COMMITTEE ON WAYS AND MEANS

HEARINGS BEFORE THE

SUBCOMMITTEE ON OVERSIGHT (Volume 1 of 2)

104th Congress 1995-1996

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COMMITTEE ON WAYS AND MEANS

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SUBCOMMITTEE ON OVERSIGHT (Volume 2 of 2)

104th Congress 1995-1996

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EARNED INCOME TAX CREDIT

HEARING

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT

AND THE

SUBCOMMITTEE ON HUMAN RESOURCES OF THE

COMMITTEE ON WAYS AND MEANS HOUSE OF REPRESENTATIVES

ONE HUNDRED FOURTH CONGRESS

FIRST SESSION

JUNE 15, 1995

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EARNED INCOME TAX CREDIT

THURSDAY, JUNE 15, 1995

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON OVERSIGHT, JOINTLY WITH
THE SUBCOMMITTEE ON HUMAN RESOURCES,
Washington, DC.

The Subcommittees met jointly, pursuant to notice, at 10:20 a.m., in room 1100 Longworth House Office Building, Hon. Nancy L. Johnson, (Chairman of the Subcommittee on Oversight) and Hon. E. Clay Shaw, Jr., (Chairman of the Subcommittee on Human Resources) presiding.

[The advisory announcing the hearing follows:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

SUBCOMMITTEES ON OVERSIGHT AND HUMAN RESOURCES

FOR IMMEDIATE RELEASE June 2, 1995 No. OV-8 CONTACT: (202) 225-7601

Johnson and Shaw Announce Hearing on the Earned Income Tax Credit

Congresswoman Nancy L. Johnson (R-CT), Chairman of the Subcommittee on Oversight, and Congressman E. Clay Shaw, Jr. (R-FL), Chairman of the Subcommittee on Human Resources of the Committee on Ways and Means, today announced that the Subcommittees will hold a joint hearing on the Eurned income Tax Credit. The hearing will take place on Thursday, June 15, 1995, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 10:00 a.m.

This hearing will feature invited witnesses only. In view of the limited time available to hear witnesses, the Subcommittees will not be able to accommodate requests to testify other than from those who are invited. Those persons and organizations not scheduled for an oral appearance are welcome to submit written statements for the record of the hearing.

BACKGROUND:

To be eligible to receive the Earned Income Tax Credit (EITC), an individual must have earned income. To target the credit to low-income workers, the amount of the credit to which a taxpayer is entitled decreases when the taxpayer's earned income (or, if greater, adjusted gross income (AGI)) exceeds certain thresholds. The earned income and AGI thresholds are indexed for inflation and are also adjusted to take into account qualifying children. In 1995, a taxpayer with two or more qualifying children will not be eligible for the EITC if his or her income exceeds \$26,673. The income cut-offs decline to \$24,396 for a taxpayer with one qualifying children.

SCOPE OF THE HEARING:

There are three major EITC issues which the Subcommittees intend to examine. First, based on studies by both the Internal Revenue Service (IRS) and the General Accounting Office, there is an alarmingly high rate of errors and fraud in EITC claims. According to IRS data, the noncompliance rate could range as high as 30 to 40 percent annually. Given the fact that the federal government will spend between \$25 and \$28 billion per year over the next five years on EITC benefits, the loss to the taxpayers from noncompliance could be very high. The IRS took significant steps during the current tax filing season to detect erroneous and fraudulent EITC refund claims. The Subcommittees will examine the effectiveness of the IRS' efforts and whether additional changes are needed to reduce the credit's susceptibility to fraud and errors. We are especially interested in learning whether, as some tax experts have recently argued, fraudulent claims are an inevitable consequence of the value and refundable nature of the EITC benefit.

The second issue to be addressed is whether inappropriate beneficiaries may be receiving the EITC. Under current law a taxpayer may have relatively low earned income, and therefore may be eligible for the EITC, even though he or she may have other significant sources of nontaxable income. Although the credit is intended to help low-income workers, its eligibility criteria does not include all of the resources recipients may have to support their families. Earlier this year, the Administration proposed denying the credit to taxpayers with \$2,500 or more of interest and dividend income. This Administration policy was based on the rationale that the EITC should be targeted to families with the greatest need, not those with

WAYS AND MEANS SUBCOMMITTEES ON OVERSIGHT & HUMAN RESOURCES PAGE TWO

other resources upon which they can draw to meet family needs. The Subcommittees will examine the implications of changing the credit's eligibility criteria to take into account sources of income that are not currently counted for eligibility purposes.

The Subcommittees are also interested in receiving testimony on the labor market effects of the EITC. As long ago as 1990, the Ways and Means Committee heard testimony expressing concern that the EITC could actually reduce the aggregate level of work in the nation. This effect could occur because earners in the flat range of the credit may have reduced incentive to work additional hours. Even more important, the millions of earners in the phase-out range have an unambiguous incentive to reduce hours of work. The Subcommittees will examine the concern that the credit's large phase-out range may lead to a net reduction in work.

In announcing the hearing, Chairman Johnson said: "Even advocates realize that there are problems with the EITC. Rather than put our heads in the sand while these problems fester, we should take strong action now to make certain the EITC will remain available for the millions of American low-wage parents, especially those trying to leave welfare, who use the EITC exactly as it was intended." Chairman Shaw added that: "This hearing is very important because the design of the EITC has invited fraud. As we maintain the core of this program, we must root out the excesses.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Any person or organization wishing to submit a written statement for the printed record of the hearing should submit at least six (6) copies of their statement, with their address and date of hearing noted, by the close of business, Thursday, June 29, 1995, to Phillip D. Moseley, Chief of Staff, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filling written statements wish to have their statements distributed to the press and interested public at the hearing, they may deliver 200 additional copies for this purpose to the Subcommittee on Oversight office, room 1136 Longworth House Office Building, at least one hour before the hearing begins.

FORMATTING REQUIREMENTS:

- Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines histed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the
- 1. All statements and any accompanying exhibits for printing must be typed in single space on logal-cise paper and may not exceed a total of 10 pages including attachments.
- Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material about to revenued and quested or paraphrased. All exhibit material ast mooting those specifications will be maintained in the Committee files for review and use by the Committee.
- 3. A witness appearing at a public hearing, or submitting a statement for the record of a public hearing, or submitting written comments by the Generalized, must hedude on his statement or submittees a list of all effects, person, or expanizations on whose behalf the witness appears.
- 4. A repplemental about must accompany each statement listing the name, full address, a telephone number where the witness or the definition representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. This appreciance about will not be included in the printed record.

The above restrictions and limitations apply only to material being rabmitted for printing. Statements and exhibits or supplementary material submitted colorly for distribution to the Members, the press and the public during the owner of a public hearing may be exhautted in the form

Note: All Committee advisories and news releases are now available over the Internet at GOPHER.HOUSE.GOV, under 'HOUSE COMMITTEE INFORMATION'.

Chairman JOHNSON. The hearing will come to order.

My colleague, Chairman Shaw of the Human Resources Subcommittee, will be joining us briefly. In the meantime, I would like to welcome you all to this hearing, a joint hearing of the Oversight and Human Resources Subcommittees of the Ways and Means Committee on EITC, the earned income tax credit.

The EITC was first enacted into law in 1975 to offset the impact of FICA taxes and to help encourage those on welfare to enter the work force. The EITC was designed to reduce reliance on AFDC, Aid to Families With Dependent Children, and other transfers by

increasing the aftertax return for work.

With a focus of welfare reform on moving people from dependence on welfare benefits to the independence of work and earnings, the EITC plays a very important role, but the cost is high. Under current law, approximately 19 million families vill receive the credit in the year 2000 at an annual cost of almost \$30 billion, nearly double what the Federal Government will spend on welfare benefits, and well over two times the \$13 billion the government will spend on education.

Advocates realize that there are problems with the EITC. If we expect this important benefit for low-income workers to survive, we certainly cannot afford to lose the \$5 billion per year that Treasury and the IRS, Internal Revenue Service, estimate we have been losing to fraudulent and erroneous claims.

The credit susceptibility for fraud and errors is apparently due largely to its refundable nature and the fact that the amount of the credit a taxpayer receives is determined by information supplied by

the taxpayer and not readily verifiable by the IRS.

In addition, the standards of proof required in the EITC claims are not comparable to the standards of proof required for receipt of other government benefits such as AFDC, Medicare, and unemployment compensation. Establishing eligibility for these benefits normally requires the claimant to meet with government employees face-to-face to produce proof of identification, and other qualifying information. These controls are not part of the EITC Program.

During the 1995 filing season, the IRS took a number of steps to address erroneous and fraudulent EITC claims, and this morning we are going to hear about those efforts and their outcomes. Even if the IRS were able to perfectly verify SSNs, Social Security numbers, and wage and salary income, compliance problems would

still arise with regard to self-employment.

As long as the payroll tax and the EITC subsidy are roughly equal, taxpayers have no incentive to overstate income from self-employment to increase their EITC. Doing so would result in a larger credit, but would also obligate the taxpayer to pay higher Social Security taxes on their self-employed income.

As a result of recent expansions of the EITC, there are now strong incentives for taxpayers to manipulate the level of their income from self-employment. The IRS is not equipped well enough

to uncover overreporting of income.

Today we will hear more from the IRS about the results of their fraud prevention efforts and some indication of what can be expected next year to further protect the Nation's revenues. Assistant Secretary Samuels will also give the administration's views on reforms to the credit, and we will hear testimony about how to further reduce the credit susceptibility to fraud and errors and how to better target the credit to those who need it most.

I would like to submit my entire statement for the record and acknowledge my cochairman, Mr. Matsui of California of the Over-

sight Subcommittee.

The opening statement follows:]

Opening Statement by the Honorable Nancy L. Johnson Subcommittees on Oversight and Human Resources Joint Hearing on the Earned Income Tax Credit Thursday, June 15, 1995

Good morning ladies and gentlemen. I welcome you to this joint hearing of the Oversight and Human Resources Subcommittees on the Earned Income Tax Credit.

The EITC was first enacted in law in 1975 to offset the impact of FICA taxes to help encourage those on welfare to enter the workforce. Thus, the EITC was designed to reduce reliance on AFDC and other transfers by increasing the after-tax return to work. With the focus of welfare reform on moving people from dependence on welfare benefits to the independence of work and earnings, the EITC plays an important role.

But the cost is high. Under current law, approximately 19 million families will receive the credit in the year 2000, at an annual cost of almost \$30 billion — nearly double what the federal government will spend on welfare benefits and well over two times the \$13 billion the government will spend on education.

Even advocates realize that there are problems with the EITC. If we expect this important benefit for low-income workers to survive, we certainly cannot afford to lose the \$5 billion per year that Treasury and the IRS estimate we've been losing to fraudulent and erroneous claims.

The credit's susceptibility to fraud and errors is apparently due largely to its refundable nature and the fact that the amount of the credit a taxpayer receives is determined by information supplied by the taxpayer. Much of this information cannot be verified by the IRS at the time the refundable portion of the credit is paid out.

In addition, the standards of proof required on EITC claims aren't comparable with the standards of proof required for receipt of other government benefits such as AFDC, Medicaid or unemployment. Establishing eligibility for these benefits normally requires the claimant to meet with government employees face-to-face, to produce proof of identification, to prove the existence of their dependents, and to satisfy other conditions. These controls aren't available in the distribution of the EITC by the IRS through tax refunds.

During the 1995 filing season, the IRS took a number of steps to address erroneous and fraudulent EITC claims. Among other things, the IRS delayed refunds on *all* returns with an invalid or missing Social Security number to give greater time to verify the refund being claimed. It also checked the validity of all Social Security numbers, and checked for duplicate use of the same numbers.

The preliminary evidence suggests that these checks will help somewhat to reduce the losses from fraudulent claims. For example, through May 21, 1995, the number of dependents claimed for tax year 1994 when compared to the number claimed through the same time period last year, decreased by approximately 800,000. The IRS believes this is probably due to the fact that non-existent or non-qualifying dependents claimed in prior years were not claimed this year — perhaps because of publicity surrounding the fact that the IRS would verify Social Security numbers.

But even if the IRS were able to perfectly verify Social Security numbers and wage and salary income, compliance problems would still arise with regard to self-employment income. Between 1975 and 1990, the subsidy rate of the EITC was roughly the same as the combined employee and employer share of the payroll tax.

As long as the payroll tax and EITC subsidy are roughly equal, taxpayers have no incentive to overstate income from self-employment to increase their EITC. Doing so would result in a larger credit, but would also obligate the taxpayer to pay higher social security taxes on the self-employment income.

However, as a result of recent expansions of the EITC, there are now strong incentives for taxpayers to manipulate the level of their income from self-employment, and the IRS isn't well equipped to uncover overreporting of income.

Our tax laws and administrative safeguards are generally designed to identify cases where taxpayers understate their income, not overstate it. For example, information reports such as 1099s allow the IRS to verify that taxpayers haven't omitted items of income on their tax returns. However, if taxpayers voluntarily report more income than the information reported to the IRS suggests, there's little the IRS can do to detect this in the absence of a full-scale audit, and the payoffs to audits in this area are small relative to other areas.

Today, we'll hear more from the IRS about the results of their fraud prevention efforts and some indication of what can be expected next year to further protect the nation's revenues. Assistant Secretary Samuels will also give us the Administration's views on reforms to the credit. We will hear testimony about how to further reduce the credit's susceptibility to fraud and errors, how to better target the credit to those who need it most, and the credit's impact on incentives to work.

Rather than put our heads in the sand while problems with the EITC fester, we should take action now to make certain the credit will remain available for the millions of American low-wage parents, especially those trying to leave welfare, who use the EITC exactly as it was intended.

I welcome all our witnesses today and thank them for their willingness to testify.

Mr. MATSUI. I would like to thank Chairman Johnson first of all for holding these hearings. Second, I would like to thank the Chair for the fact that she and her staff, in working with our staff, came up with a very good witness list, one in which I think we will get a positive airing of both the problems and solutions on the issue of the EITC. I want to thank you for the way this has been handled.

Chairman JOHNSON. Our staff has worked together very well, as have we.

Mr. MATSUI. Thank you.

I welcome my colleagues, Mr. Petri and Mr. Hutchinson, and certainly the two administration witnesses, the Assistant Secretary for Treasury, Mr. Samuels, and the Commissioner of the Internal

Revenue Service, Peggy Richardson.

Let me, if I may, be very brief, but make four observations, Chairman Johnson. One, the purpose of the earned income tax credit is to do two things. It is to move people from welfare to work. Many low-wage earners do not make enough, particularly if they are at the minimum wage level, in order to make a decent living and survive, as a result of that, the earned income tax credit, which was first imposed in 1975 and then extended in 1990 and 1993, and also in 1986 in tax reform, is to provide an incentive to continue to work and to get off welfare. Second, it is to make sure that families that work and who have children find a way to get out of poverty. Those are the two basic elements of the earned income tax credit.

I would disagree with the observation that some make, including in the opening statement of the Chair, that the earned income tax credit has become a disincentive for people to work, because now the threshold is approximately \$29,000. A family of three or four making \$29,000 would not have any excess income to save and put in a bank account or perhaps buy a house and, as a result of that, they are going to need every penny they make.

We are not talking about people that make \$200,000 or \$300,000 a year that might have excess income so they do not need to earn any more money to live. We are talking about people really on the threshold. Anybody under \$30,000 with three or four in their family in America today cannot make it unless they continue to work

and work and work.

I would like to also respond to the issue of the growth of the program. I know that there has been some allegations in the press reports and others that the earned income tax credit is exploding in growth and we need to stop it and we need to reform it.

As I mentioned, in 1986 we had the first major expansion. In 1990, under President Bush—because it has always been bipartisan—we had another expansion, and then we had the third recent

expansion in 1993. These are still being phased in.

Of course, as they are being phased in, the program will grow. By the year 1997, the full phase-in will occur, and after that I can assure you that the only growth will be the result of indexing the rates and also population growth. We do not expect a growth anywhere in excess of 3 or 4 percent, whatever inflation should be, and I believe we will have charts to show that.

It is false to say that this program is exploding and will ultimately create a deficit problem. We knew exactly what we were doing under President Bush in 1990. We knew what we were doing under President Reagan in 1986, and we knew what we were doing in 1993 under President Clinton, and that program will fully phase in in 1997 and the growth will be exactly what all taxpayers receive in terms of the indexation of inflation.

The third area and the second point I would like to make is the issue of the error rate, which everyone has seemed to make a big deal about. First of all, it was the Treasury Department and IRS under President Clinton which recently decided to examine the EITC. They found that there could be some problems with approximately 29 percent of the filers making errors on their returns. Of course, that is a rather high alarming number. At the same time, that does not mean 29 percent of benefits were paid out. It means that errors were made in an individual's return.

Second, bear in mind that when that very limited study was done, it was only on electronic filing. It was not on the paper returns that many low-income taxpayers file. It was electronic filing, which most low-income people do not do. That is what actually caused the IRS and Treasury to have their ears perk up and say we had better check these numbers. That was, as I said, in January 1994.

Since that time, the Treasury Department has commissioned a study that came out in September 1994, from that study, they made a number of observations and now they have come up with a number of recommendations, for example, during GATT, the General Agreement on Tariffs and Trade, discussions when we matched the Social Security number of the individual claiming the credit with the return.

We made changes on electronic filing, and now the person on the first electronic filing cannot file unless they provide decent verification. As a result of that, we have now been able to identify in this filing year 4.1 million returns that have errors, and so the service and also Treasury are correcting this problem. Second, they have made additional recommendations, both to the Congress and also in terms of regulations, that we believe will actually satisfy the problem.

Let me conclude by making one last observation, if I may. I think that to some extent we need to talk about this issue in the context of the larger issue of our Tax Code. We are talking about approximately \$20 to \$25 billion a year for low-income wage earners, people that work, not people that are on welfare.

At a time when we just passed the budget resolution, that gives each person making over \$100,000 a year, over \$12,000 in tax reductions, an individual taxpayer with a family of three making under \$30,000, will get maybe \$1,500 or \$1,900. Penalizing these families and restrict them from getting this credit at all, was agreed to on a bipartisan agreement. We really need to consider and think about what our values are in America today.

I look forward to these hearings, Chairman Johnson and other Members of this Subcommittee and Committees. At the same time, I hope that we do not do something that will create a disincentive for Americans to work and actually do major harm to the children of America.

Thank you.

Chairman JOHNSON. Thank you.

I yield now to my cochair of this hearing, Mr. Shaw, with the comment that some of the Members who have been waiting to testify have some pretty severe deadlines, and so we will move forward.

Chairman SHAW. Madam Chairman, at this point I would ask that my opening statement be made a part of the record in order to expedite this hearing.

[The opening statement follows:]

Opening Statement by the Honorable E. Clay Shaw Subcommittee on Human Resources Joint Hearing on Earned Income Tax Credit Thursday, June 15, 1995

By almost any account, the Earned Income Tax Credit has been one of Washington's most popular anti-poverty programs. The number of beneficiaries, the generosity of the credit, and the cost to taxpayers have all grown dramatically under Presidents Reagan, Bush and Clinton. And the fundamental premise of the EITC -- that government programs should reward poor Americans who work rather than those who do not and rely on welfare -- has now become almost the fifth gospel here in Washington. I'll call it the gospel according to Charlie, after my good friend Charlie Rangel.

Yet we are now hearing new criticisms of the EITC. The Green Book, for example, tells us that 168,000 people with incomes over \$40,000 received the EITC. Even more troubling allegations involve fraud and abuse costing taxpayers billions of dollars. One witness at a recent Senate hearing said the EITC should stand for "Easy Income for Tax Cheats." Make no mistake about it -- this Subcommittee will act to defend the EITC against continued abuse.

The Subcommittee also will consider whether the EITC's eligibility criteria should be changed so that only families without other resources are eligible for the credit. For example, earlier this year the Administration proposed targeting the EITC to families with less than \$2,500 in interest and dividend income. A version of this proposal is now law, and we will explore the implications of related changes for families that benefit and taxpayers who support them. We will also examine whether current EITC rules actually may reduce the time some poor families spend working.

Finally, both Republicans and Democrats want the EITC to help parents get off and stay off welfare. Yet the Committee has received disturbing information that most welfare mothers, even those who work, have only the foggiest notion of what the EITC is all about. Welfare departments intent on helping mothers leave welfare must begin programs designed to teach mothers about the EITC. We have invited an entire panel of witnesses to address this issue.

Despite the fact that problems exist, many Americans believe the EITC remains an important part of our country's efforts against poverty. I am one. The EITC helps poor families with children or single parents escape and stay off welfare. It also increases the chances that poor children will learn from their parents the value of work. That lesson is one of the most important any parent can pass on to a child, yet in some parts of our country a personal understanding of the value of work is almost unknown. Until someone suggests a better alternative, the EITC will remain our best bet to reinforce the importance of work, not welfare, for millions of poor families.

Chairman SHAW. I would now recognize the gentleman from Tennessee, Mr. Ford, for any opening statement he might have.

Mr. FORD. Thank you very much, Chairman Shaw and Chairman Johnson. Let me thank the two cochairpersons for calling these hearings today.

I am going to be very brief, and I ask that my full text be made

a part of the record, if you do not mind, Madam Chairman.

Some have proposed to cut the EITC either by indexing or by a halt in the phased-in increases we have mandated. Make no mistake about it, cuts in the EITC constitutes a tax increase on millions of hard-working Americans who in most cases have very low wages and low income.

Chairman Archer, the Chairman of the Full Committee on Ways and Means, has made it clear that tax increases will not occur on his watch, and I am counting on him to make certain that his pledge apply equally to working poor people, as well as to the rich

and wealthy of this Nation.

I think when we think in terms of the earned income tax credit—and I think Mr. Matsui has said it very well—under both Democrats and Republicans in the White House, we have seen over a 10-year period a program that has expanded. The expansion was the intent all along on a bipartisan basis. It would be expanded to make sure that working Americans can move off many of the public assistance rolls and stay within the work force and bring in wages, and also under the EITC Program, that they would be able to have the necessary benefits that will be needed. It should come as no surprise that spending on this program has now increased because that is what we intended for this program all along.

I once again thank you, Madam Chairman and Chairman Shaw, for calling these public hearings today. Hopefully, we, as Republicans and Democrats, can address this problem on the EITC

and make sure that we move forward in the right direction.

Thank you.

[The opening statement follows:]

OPENING STATEMENT OF REPRESENTATIVE HAROLD FORD June 15, 1995

Today's hearing is an important one because it gives us a chance to examine the facts and dispel several myths that seem to haunt the EITC.

For example, critics charge that spending on the EITC is out-of-control. They are correct that EITC spending has grown. But that is because the Congress, under the leadership of both Republican and Democratic Presidents, decided that it should grow. Over the past ten years, we have repeatedly expanded the EITC — as a reward for work and as an alternative to increasing the minimum wage. It should come as no surprise that spending on this program has now increased. This is what we intended.

Some have proposed to cut the EITC, either by ending indexing or by halting the phased-in increases we mandated.

Make no mistake. Cuts in the EITC constitute a tax increase on millions of hardworking Americans.

Chairman Archer has made clear that tax increases will not occur on his watch. I am counting on him to make certain that pledge is applied equally – to the working poor as well as the idle rich.

Talk about cutting the EITC is motivated – first and foremost – by the need to pay for the tax cuts Republicans have proposed for the wealthy. But clever advocates of tax cuts for the rich are using alleged fraud in the EITC as a smoke screen to hide their true intent.

Let me be clear. Any fraud is unacceptable. Congress has taken legislative steps to address errors and fraud in the EITC. The Clinton Administration has proceeded aggressively to reduce the error and fraud rates they inherited in 1993. If additional legislative or administrative action is needed, let's do it. But we cannot allow unfounded allegations of widespread fraud to be the reason we carve up a program that helps millions of working Americans succeed in their climb out of poverty.

I know that many of my Republican colleagues share this commitment to the EITC. I look forward to today's testimony and to working with you to preserve this valuable anti-poverty tool.

Chairman SHAW. Thank you, Mr. Ford.

If the first panel would sit at the witness table. Mr. Petri, we have you down first. If you would not mind, let Mr. Hutchinson go first, because he has a conflict with another hearing here in the Capitol.

The Chair at this time will recognize Tim Hutchinson from the

State of Arkansas.

STATEMENT OF HON. Y. TIM HUTCHINSON, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF ARKANSAS

Mr. HUTCHINSON. Thank you, Mr. Chairman. Thank you, Mr. Petri, for allowing me to go first. I appreciate the Committee's indulgence. I know Mr. Petri will be able to handle all the questions that you will have when I excuse myself.

I want to commend you for holding this hearing on the EITC, program which former President Ronald Reagan called the be antipoverty, profamily, job-creation measure to come out of the comment of the com

Congress.

Unfortunately, in many ways the EITC has strayed far from its original mission. It was designed as a small supplement to help compensate working families who pay payroll taxes. It has evolved into an alternative to traditional forms of welfare assistance. In addition, as it currently stands, the EITC is prone to serious abuse and fraud and is flawed in its design. We need to rethink its construction.

Mr. Chairman, as you know, I have been active in the welfare reform debate. I think that redesign of the EITC is the logical next step in welfare reform. As we continue to work toward the overhaul of our welfare system and the goal of making people more independent, I believe the EITC can be a very valuable tool in this endeavor.

Our Senate colleagues have proposed to roll back the 1993 EITC expansion in their fiscal year 1997 budget resolution. While I do not agree with the Senate action in their proposal, I do think it may be useful for House members to consider many of the reforms in the Senate proposal in a comprehensive overhaul and repackaging of the program.

I have been working on EITC reform legislation. Since the purpose and configuration of the EITC has changed so dramatically over the years, I am calling my legislation the Minimum Wage for Families Act to more accurately represent what I think is the real objective of the EITC. My proposal would make the EITC more

profamily and more promarriage.

Under the ever-expanding EITC, single individuals have been made eligible, and families with children in college receive benefits. We need to focus only on families with children, especially those under the age of 18. Disincentives to marriage have developed, as the size of the credit has increased. The bill would change that by incorporating a one-time \$2,000 marriage credit. Lump-sum payments, since they were very small at first, made sense. Now they do not and we need to change that.

My bill would make the EITC practically useful by prorating the EITC over the 12 months of the year. In addition, I would draw

from the previous work done by my colleague Nathan Deal to make

it easier for the EITC to be payable in advance.

Further, my legislation would link the EITC to other welfare programs. We need to do this. Hard-working families should receive direct cash assistance, instead of food stamps. We accomplish this goal by expanding cash benefits under EITC and including those cash benefits when determining eligibility for other traditional welfare programs. This change would empower working families to make more of life's decisions themselves by replacing traditional welfare programs with a cash payment.

In line with President Clinton's proposal, the bill would deny EITC eligibility to individuals who are living in the United States illegally or who do not have proper documentation for employment

purposes.

Mr. Chairman, for too long we have been locked in a sterile thirties debate on the concept of minimum wage. We need to break out of that way of thinking by allowing businesses to hire as many workers as they can, pay market wages and utilize government to take family incomes up to a minimum standard of living. An increase in EITC cash payment would mitigate any need for a minimum wage increase.

Under my proposal, a family with two dependents earning the current minimum wage will make \$7 an hour in total compensation. A family with one dependent will take home \$6 an hour. By supplementing employer provided wages with direct cash assistance from the Federal Government, we do not arbitrarily raise the cost of labor to business and destroy jobs for the very people we are

trying to help leave the welfare rolls.

In addition, this proposal conforms to our recently passed budget resolution. Estimates conducted by CBO, the Joint Tax Committee, and my staff on various specifics of the proposal indicate that the overall savings over 5 years from these reforms would be in the \$20

to \$30 billion range.

Mr. Chairman, the EITC needs to be returned to its original purpose. I think we have a golden opportunity and we should take this opportunity to implement the necessary reforms, and I look forward and welcome the opportunity to work with you and your colleagues on this Subcommittee to bring about constructive and productive changes in the EITC Program.

I thank you for the opportunity to visit with you today.

Chairman SHAW. Thank you, Mr. Hutchinson. You have certainly been one of the leaders in the House on welfare reform, and I think you quite correctly recognize that the EITC is a very important ingredient to welfare reform.

Thank you very much.

Mr. HUTCHINSON. Thank you. Thank you for your indulgence on allowing me to be excused.

Chairman SHAW. Tom Petri from the State of Wisconsin, welcome.

STATEMENT OF HON. THOMAS E. PETRI, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF WISCONSIN

Mr. PETRI. Thank you very much. I appreciate the opportunity to testify here today.

The EITC is a vital adjunct of welfare reform and a far better way to help the working poor than is an increase in the minimum wage. In particular, the EITC is also the best way to help families with the expenses of child care, since it does not discriminate against parents who stay home and forgo income in order to care for their own children.

Many of us now believe there should be no such thing as welfare as we have known it for able-bodied people. It produces dependency and is profoundly demoralizing to those who struggle to support themselves without public assistance. Instead, the basic income for all able-bodied people should come from work—publicly supplied, if necessary. Wages alone are not enough for those with families and only minimum wage skills. They need a credit or voucher to help them buy a health plan and a wage supplement geared to their family size.

The EITC is the best way to supplement wages. It is universal and, therefore, without stigma or demoralizing effects. It can be adjusted for need as determined by both family size and earnings. Unlike a minimum wage increase, the EITC does not remove the first rung of the employment ladder for those with the least skills, and it helps millions earning more than the minimum wage.

The current EITC, however, contains serious flaws which must and can be fixed. First, it includes childless people who do not need it as much as others because they would be well above the poverty line without it, if they worked full time. That feature should be

eliminated, saving about \$1 billion next year.

Second, in its phase out range for families with incomes between \$11,000 and \$27,000, the current EITC imposes high marginal tax rates of 21 or 16 percent. When combined with Federal and State income taxes, Social Security taxes, food stamp, and housing subsidy phaseouts, and a possible future Medicaid voucher phaseout, this can create total marginal tax rates exceeding 100 percent, completely removing any incentive to improve earnings. We need to take a coordinated look at the combined incentive effects of all these kinds of programs, eliminating the marginal tax rates in some and reducing them in others, including the EITC.

Third, the current EITC contains grotesque marriage penalties. The extreme case is a couple, each earning \$11,000, with four kids. As two single-parent two-child households, they get \$6,740 of EITC next year. As one \$22,000 income household, they get only \$1,060. The EITC marriage penalty for that couple is \$5,680, and they also face an income tax marriage penalty of \$750 and other penalties

in other programs.

Finally, the current EITC provides no extra help to families with

the greatest need; that is, those with more than two kids.

Fortunately, we can solve all these problems by modifying the \$500 child credit in the Contract With America and coordinating that with the EITC. At the same time, we will get a good compromise with the Senate on the child credit issue. I have three versions of this compromise costing one-quarter, one-half and three-quarters of the cost of the \$500 child care credit. I will describe the three-quarters version briefly.

First, increase the child credit to \$1,100, and at the same time, eliminate the personal exemption for children under 18. This pro-

duces a net tax cut per child next year as follows: In the 15-percent tax bracket, a tax cut of \$718; in the 28-percent bracket, \$386 per child; in the 31-percent bracket, \$310 per child; the 36-percent bracket, \$192; and in the 39.6-percent income tax bracket, a reduction in taxes of \$90 per child.

Now that is progressive, but very competitive with the flat \$500 credit. Lowest bracket taxpayers get much more, the 28-percent bracket almost as much, even in the 31-percent bracket, taxpayers

get three-fifths as much.

Next, for the real payoff, integrate the \$1,100 credit with the EITC by making it refundable for those with earned income. Since it is a universal credit, it does not need to be phased out. You give that credit to high-income, as well as low-income people, and that was in the contract. Then change the EITC to a credit of \$1,000 per parent, phasing out single parents between \$9,000 income and \$19,000 income, and couples between \$16,000 and \$36,000 income. That cuts the worst case marriage penalty from \$5,680 to \$200, cuts the marginal tax rate in the phaseout to 10 percent. Both of these results are enormous improvements.

There are charts that accompany my submitted testimony. Under the illustrations in those charts, all lower income two-parent families get much larger credits than under current law. Single-parent families with incomes under about \$20,000 generally do slightly worse than under current law, but only slightly, and that is the price we have to pay for eliminating the marriage penalty. Of course, if they have more than two kids, they do much better.

Let me close by reviewing the advantages of this kind of integrated approach. One, it is less expensive. It provides a good compromise with the Senate. The tax cuts are progressive, but very competitive with the flat \$500 credit. The credit itself is more than doubled. The EITC marriage penalty is practically eliminated, marginal tax rates are slashed, and larger families get the help they need.

Finally, we support welfare reforms in which the basic income of the able bodied is wages plus general credits plus a general health plan voucher.

Mr. Chairman, we need the EITC to make welfare reform work. The current version has problems, but let us fix them, not do away with the whole program.

Thank you very much for your attention.

[Attachments to the prepared statement follow:]

KILLING MANY BIRDS WITH ONE STONE: A CHILD TAX CREDIT COMPROMISE THAT COSTS LESS BUT FURTHERS WELFARE REFORM OBJECTIVES

PROBLEMS TO BE SOLVED:

- 1. Need House-Senate tax compromise on child credit;
- 2. Current earned income tax credit (EITC) -- a vital adjunct to welfare reform because it enables low-skilled people with kids to support themselves by working -- has 3 big flaws:
- a. contains high marginal tax rates (21% or 16%) during phaseout -- when combined with other taxes and phaseouts (i.e. food stamps, housing subsidies, and a possible medicaid voucher), removes any incentive to get ahead because total marginal tax rate can top 100%;
- b. contains high marriage penalties (\$5680 + \$750 income tax penalty in extreme case);
 - c. provides no extra help to larger families with greatest need.

SOLUTION:

 For kids under 18, eliminate personal exemption (\$2550 in '96) and substitute \$1100 credit -- provides net tax cut per child by bracket in '96 as follows:

15%	bracket	(abo	out 0	to	\$40K	TAXABLE	196	jt.	return	income)	 \$718
28%	41	("	40K	11	97K	11	u	"	"	ıı j	 \$386
31%	11	("	97K	16	148K	11	11	**	11	")	 \$310
36%	11	("	148K	11	265K	II .	11	**	11	")	 \$182
39.6	% "	Ì	01	ver	265K	н	11	н	11	" j	 \$ 90

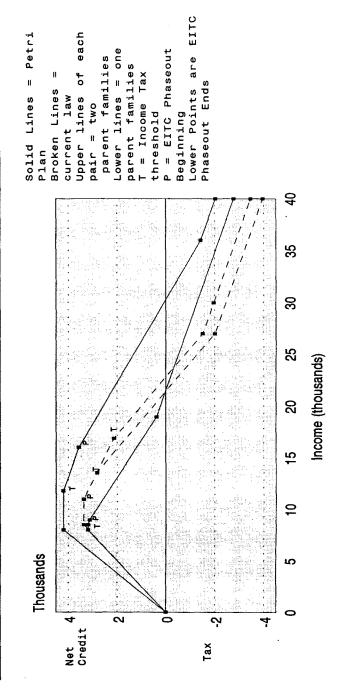
- 2. Universal \$1100 credit is refundable for those with earned income and substitutes for a major portion of the EITC -- no phaseout necessary because everyone gets it. Provide extra EITC to PARENTS -- maximum of \$1000 per parent -- phasing out for a single parent between \$9000 and \$19,000 income at a rate of 10%, and for two parents between \$16,000 and \$36,000 income at 10%.
- 3. Provide no other EITC; eliminate current EITC for childless people.
- 4. Optional (to save money): eliminate dependent care credit, which is unfair to parents who forgo income to take care of their own kids.

ADVANTAGES:

- Costs approximately 3/4 as much as flat \$500 credit;
- Tax cut is progressive;
- 3. Credit itself is doubled;
- Maximum EITC marriage penalty cut from \$5680 to \$200;
- EITC marginal tax (i.e. phaseout) rates cut from 16% & 21% (based on number of kids) to 10%;
- Provides extra \$1100 per child for WORKING poor families with more than two kids;
- Supports welfare reform in which basic income of able-bodied is wages plus general tax credits plus a general health plan voucher;
- Eliminates messy overlap between new credit and EITC;
- Though single parents with 1 or 2 kids get slightly less than current EITC, all two parent families get much more;
- 10. Hidden effect: cuts unnecessary EITC for students over 18;
- 11. Probably makes it easier for President Clinton to sign the bill.
- Shows Republicans can integrate several objectives in one creative solution.

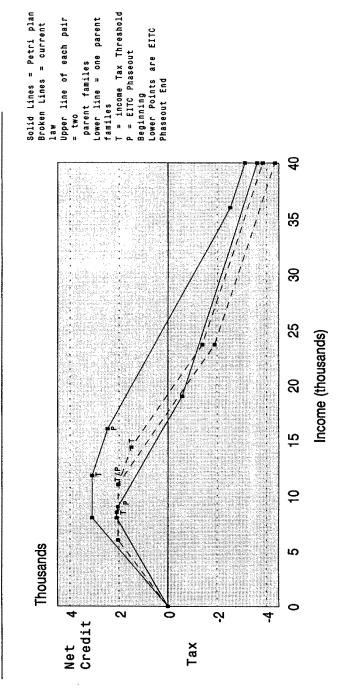
Combined Effects of Income Tax & EITC Petri Plan vs. Current Law

Two Child Families



Combined Effects of Income Tax & EITC

Petri Plan vs. Current Law One Child Families



Chairman JOHNSON. Thank you very much, Tom, for your very thoughtful testimony. You have been working on this legislation for about a decade now, and the depth of your knowledge is going to be a great help to us as we look at the problems that have developed.

Are there questions of Mr. Petri by the Members?

Mr. Gibbons.

Mr. GIBBONS. Madam Chairman, I just want to commend our colleague Tom Petri. I thought that was an excellent analytical workout of the problem we face and I want to tell you I am going to take your testimony and read it very closely. Both you and Mr. Hutchinson I thought were very constructive in your suggestions. I commend you for it.

Mr. Petri. Thank you. I think the one thing above all that you do as you work in this area is attempt to look at it from the point of view of the individual, rather than from the point of view of the advocates of each of the different programs. Integrate them, because otherwise you would get the law of unintended consequences—we will get it anyway, but it will get a lot worse as we find with things like the marriage penalty, which no one wants, but is the consequence of the current array of programs that we have got.

Mr. GIBBONS. Good thinking. Mr. RANGEL. Madam Chairlady.

Chairman JOHNSON, Mr. Rangel, Mr. RANGEL, I do not recall you

Mr. RANGEL. I do not recall your exact words, but it was something to the effect that a single person could do better if they worked full time. It is an assumption that there is full-time employment and that the worker would prefer to have a lower EITC by having a lower salary. Could you explain that? It is the first objection that you had.

Mr. Petri. I am having a little trouble hearing the question, but I think you were—

Mr. RANGEL. The current EITC, however, contains serious flaws which must and can be fixed. First, it includes childless people who do not need it because they would be well above the poverty line without it. My question follows, if they worked full time, it would save \$1 billion. Why would a person without a child want not to work full time? What makes you assume that they have elected to work part time in order to receive EITC?

Mr. Petri. I actually amended that testimony as I gave it to say it includes childless people who do not need it as much as others, that is to say, people with children.

Mr. RANGEL. Why would they not need it as much because they have a child?

Mr. PETRI. Because they are above the poverty line, if they are working full time. Obviously, if they are not working full time, they would need it, but presumably sometimes people will elect not—

Mr. RANGEL. Could you run away from that one and say, if they are not working at all, they do not get anything. If they are working part time, should we not assume that people who are poor want to work full time?

Mr. PETRI. If they are not working at all, they should certainly get disability assistance and they should have an opportunity for some sort of employment.

Mr. RANGEL. No, no.

Mr. Petri. If they choose then not to take that opportunity, I am afraid that there are others who really do not deserve to have——

Mr. RANGEL. There is an assumption in your testimony that people who are working part time without children can and should be working full time. Of course they should be, but I am assuming that there is no full-time employment with someone at these wages. My question is why would you say look for the billion dollars for this——

Mr. Petri. There is a problem there, we should be working to make sure there are full-time job opportunities or a combination of part-time job opportunities. My part of the country is probably different than yours, but the establishments are no longer advertising sales they are advertising help wanted.

Mr. RANGEL. If they have full-time employment opportunities

and they elect part time, I agree with you.

Mr. Petri. Well, if you are a single person, you can put together a number of part-time jobs to get the same income that you can from one full time.

Mr. RANGEL. It is really not that easy. It is a problem.

Thank you.

Chairman JOHNSON. Thank you.

Mrs. Kennelly.

Mrs. KENNELLY. Thank you, Madam Chairman.

First, I would just like for the record to say what I would have said if Congressman Hutchinson was still here. He said that he thought the EITC logically was the next step in welfare reform. I would just like to put on the record that President Clinton thought of it as the first step in welfare reform, because the EITC does keep people off welfare.

I would like to ask Congressman Petri a question. Your phaseout for couples ranges up to \$36,000. Of course, that is higher than current law. What I am worried about, does that take away from a single head of household who would have a lower income? Where do you get that additional money so that it goes up to \$36,000?

Mr. PETRI. I will refer to my expert on it. Mrs. KENNELLY. I have got one of those, too.

Mr. PETRI. Would you want to come up and address that?

Mr. FLADER. That does cost more money to extend the phase out, but it is the price of reducing the phase out rate to 10 percent, and the additional cost is in the order of \$1 or \$2 billion.

Mrs. Kennelly. My worry is where do you get it? Would it affect

single heads of households with lower incomes?

Mr. Flader. You can say that it is coming from any place you want to. The overall proposal costs about three-quarters of the \$500-per-child tax credit, and the savings come partly from the overlap between the \$500 tax credit and the current EITC. It is putting those two things together that gives you the ability to make these changes in the EITC without costing more money than the \$500 credit.

Mrs. Kennelly. Congressman Petri, the reason I bring this up is in a State like mine and maybe a State like yours, we have a disparity. We are a high-income State, but the ones that need and file for the EITC are single heads of households. I would just ask you to look at that as you proceed with your proposal.

Thank you.

Mr. Petri. Thank you. We would be happy to work with you on that.

Chairman JOHNSON. Are there other questions of Mr. Petri?

Mr. Levin.

Mr. LEVIN. A quick question to my friend Congressman Petri. I think your testimony is really interesting, but the horse is out of the barn, it seems to me. The credit is in the bill that is before the conference Committee, so I do not quite understand how this Committee goes back and does the kind of integration you suggest.

Mr. Petri. As I understand it, what is before the conference Committee is the budget resolution and there is a wide disparity between the numbers in the House and Senate. However they come out, you can come up with an integrated program in this Committee that will meet easily either one-quarter, two-quarters, or three-quarters of the range you are given in the conference Committee so far as any part of this tax cut is concerned.

I assume once they agree on the budget resolution, they probably will split the difference somewhere between the Senate's \$160 billion or whatever it is and ours of \$400 or \$380 billion or something like that, and then you are going to have to come up with tax change legislation and figure out what you are going to be doing. I guess you did pass a tax bill, but——

Mr. LEVIN. This Committee passed a bill, so you are essen-

tially---

Mr. Petri. The Senate has not passed it and I am sure there will

be plenty of opportunity as you move forward.

Mr. LEVIN [continuing]. You are essentially asking the Committee, once the budget resolution is passed, to reexamine the child credit that already passed here by majority vote.

Mr. Petri. What I am suggesting is that once the conference is finished on the budget resolution and agreement is reached on what the scope of any tax cut that this Congress would deal with under that resolution this year, that you will then have plenty of opportunity, working with your colleagues in the Senate, to make modifications in the credit.

As you know, I believe there were votes over there to restrict the amount. We have some votes to restrict the coverage. My proposal is to have it phased out in a progressive way and integrated with the EITC. With any change you are going to really make at the end of the day, it seems, to be responsible, you are going to want to take this child credit, the existing personal exemption, the EITC, and other need- and size-based programs that we have got and do the best you can to integrate them, so you do not end up with screwy incentives out there for people. I look at it as an opportunity to work in a bipartisan way to turn this into something that is progressive and that is going to be helpful as we move forward in the welfare reform area.

Mr. LEVIN. Thank you.

Chairman JOHNSON. Thank you very much, Congressman Petri.

Mr. Petri. Thank you.

Chairman JOHNSON. There are no more questions, and we will invite forward Assistant Secretary Samuels and Hon. Margaret Richardson, Commissioner of the IRS.

I would remind you both that your entire statements will be made a part of the record. If you could keep your comments focused and relatively brief. We have a good attendance at the hearing and questioning will take a long time, and we do have an excellent panel following you. We would appreciate that.

Mr. Samuels.

STATEMENT OF HON. LESLIE B. SAMUELS, ASSISTANT SECRETARY FOR TAX POLICY, U.S. DEPARTMENT OF THE TREASURY

Mr. SAMUELS. Chairman Johnson, Chairman Shaw and Members of the Subcommittees, I am pleased today to discuss the targeting of the EITC, as well as steps that are being taken to improve the EITC. Commissioner Richardson will address administrative matters more completely.

The administration is strongly committed to the goals of the EITC, which are to make work pay and to lift workers out of poverty in the most efficient and administrable manner possible. With its message of "work pays," the EITC helps reduce dependency on welfare and increase reliance on jobs. This is why the EITC has been supported on a bipartisan basis during its 20-year history. During the 7 years between 1986 and 1993, Congress voted to significantly expand the EITC in three major pieces of legislation under three Presidents, the Tax Reform Act of 1986, OBRA 1990, and OBRA 1993.

In connection with developing the OBRA 1993 changes to the EITC, this administration became aware of serious compliance problems with the EITC and committed itself to do everything in our power to improve compliance. That commitment has been aggressively demonstrated in both legislative proposals and unprecedented administrative actions.

On the legislative side, OBRA 1993 repealed the two supplemental credits that had added a great deal of complexity and were extremely difficult for the IRS to verify. Last year's Uruguay round legislation contained a number of administration proposals, including extending to all children the requirement that they be identified by their Social Security number for EITC purposes. That legislation also denied the EITC to nonresident aliens and required the Defense Department to include on W-2s amounts of nontaxable earned income.

In addition, the IRS has taken bold administrative steps to address compliance issues. Commissioner Richardson will describe the more significant of these actions.

Early indications suggest that the steps we have taken in the last 2 years are working to reduce significant EITC-related errors. Yet, there is more to be done and our commitment to do so remains unwavering.

Several proposals to improve the targeting and administration of the EITC were included in the President's 1996 budget; First, the proposal to deny the EITC to taxpayers having more than \$2,500 of taxable interest and dividends was included in modified form in H.R. 831.

Under a second proposal, only individuals who are authorized to work in the United States would be eligible for the EITC beginning in 1996.

A third proposal—and this is a very important proposal —would authorize the IRS to use simplified procedures to resolve questions about the validity of a Social Security number. Under this approach, taxpayers would have 60 days in which to either provide a correct Social Security number or request the IRS to follow the more labor-intensive current-law deficiency procedures. If a taxpayer failed to respond within this period, he or she would be required to refile with correct Social Security numbers in order to obtain the EITC.

Today, we are proposing an additional change that would extend those simplified procedures to reducing EITC claims by self-employed individuals who fail to satisfy their self-employment tax liability. We welcome the opportunity to work with the Subcommittees to address areas of EITC noncompliance, just as we would like to work on addressing error rates in other areas that contribute to the overall tax gap.

During the past several months, some observers have suggested that the EITC is growing uncontrollably. To the contrary, the increases in the EITC have resulted from carefully considered actions by Congress to gradually phase in the 1990 and 1993 expansions over a period of years. Once the 1993 expansion is fully phased in in 1996, future growth will be slightly less than projected growth of gross domestic product. As you can see on the chart provided, the growth, after the EITC is fully phased in, will be less than the growth in nominal GDP, gross domestic product.

Some claim that an appropriate response to compliance concerns is substantial across-the-board reductions in the EITC. The Senate budget resolution assumed the EITC would be reduced and tax burdens increased for over 14 million working Americans. Working families with two or more children would be hit the hardest, with an average tax increase of \$305 per year. Another proposal introduced in the Senate last week would result in even greater tax increases. We do not believe that raising taxes on millions of low-income working Americans is an appropriate response to the compliance concerns.

The administration's commitment to improving the EITC has been demonstrated through more than a dozen legislative and administrative actions since early 1993. In taking these actions, we have been guided by four key goals; to make work pay for those who might otherwise be on welfare, to ensure that an individual who works full-time throughout the year will not live in poverty, to target benefits to those with the greatest needs, while minimizing distortions, and to make it easier for eligible individuals to claim the credit and for the IRS to verify their eligibility.

The design of the EITC under current law reflects a balance among these four goals. I would like to address briefly each of

them.

First, for low-income families, the EITC makes work pay in two ways. Unlike many other assistance programs for low-income families, the EITC is limited to working families. Moreover, the credit amount initially increases—rather than decreases—for each additional dollar of earnings.

The positive link between the EITC and work can help offset the work disincentives created by other tax and transfer programs, such as Social Security taxes and food stamp benefits. The EITC, with its positive credit rate on low earnings, is the only program designed to help offset the marginal tax rates imposed by the other

programs.

The expansion of the EITC in OBRA 1993 was designed to increase the effectiveness of the EITC as a work incentive. The increase in the credit rate will encourage nonworkers to enter the work force and other low-income workers to increase their hours of work. While the overall effect of the OBRA 1993 expansion cannot be measured yet, we believe that the legislation will, on net, increase work effort.

Some workers with larger families will face slightly higher marginal rates as a result of OBRA 1993. However, they are unlikely to change their behavior much in response. These are individuals who are already very attached to work force. They cannot easily adjust their hours of work in response to a small change in tax rates; they need both their jobs and the EITC to meet their day-to-day needs, and most employers will not allow them the discretion to work fewer hours. The effect of the higher marginal tax rates on some workers in the phaseout range will likely be far outweighed by the effect of the increase in the credit rate.

A second goal is to ensure that a person who works at a full-time job for the entire year will not live in poverty. In order to lift a family of four dependents with a full-time worker earning the minimum wage out of poverty would require a combination of food stamps, enactment of the President's proposal to increase the mini-

mum wage, and the implementation of the expanded EITC.

Third, the benefits of the EITC should be targeted to families with the greatest needs and to those who can be best served by the positive incentives associated with the EITC. The credit rate is highest at very low earning levels where individuals are often mak-

ing the critical step from welfare to work.

Larger families have greater needs than smaller families, taxpayers with two or more children are entitled to a larger EITC than taxpayers with one or no children. Also, by providing the EITC to families with incomes of up to \$28,524 in 1996, the program provides modest relief from the effects of wage stagnation. We believe OBRA 1993 strikes an appropriate balance between encouraging increased work effort and minimizing the distortions resulting from the phase out of the credit.

The fourth goal of the EITC is simplicity and verification. If eligibility rules are simple, taxpayers can more accurately claim the EITC and avoid costly errors. With simple and verifiable eligibility rules, the IRS can also better ensure that the EITC is paid only to taxpayers who are eligible for the credit. Consequently, we strongly urge that simplification be given weight in evaluating any

proposal.

The administration evaluates other proposals to modify the EITC by the same criteria we apply to our own proposals. We are concerned that many of the options that may be considered in the com-

ing months will not meet these criteria.

Under the Senate budget resolution, the EITC will be eliminated for workers without qualifying children, and the OBRA 1993 increases will be scaled back. We estimate that 14 million working Americans will be adversely affected. EITC recipients with two or more children would lose on average \$305 in 1996.

A bill, S. 899, has been introduced in the Senate that would result in even more severe reductions of the EITC for millions of working families. In addition to the Senate budget resolution changes, the bill would repeal indexation of the EITC and further limit eligibility by adding new restrictions on the amount and types of income received by taxpayers.

The combined effect of S. 899, once fully phased in in the year 2000, would be to reduce the EITC for 19 million taxpayers by \$602 on average. The board to my right shows the effect on EITC recipients with two or more children of both the Senate budget resolu-

tion and S. 899.

Indexation is necessary to ensure that taxpayers do not lose eligibility for the EITC. Eliminating indexing does not address non-compliance problems. Consequently, the administration strongly

opposes proposals to eliminate indexation.

S. 899 would also limit eligibility by adding new restrictions on the amounts and types of income received by taxpayers. For example, the investment income cap would be lowered from \$2,350 to \$1,000. We have serious reservations about this proposal, since it discourages savings. Also, its complexity will increase error rates.

The bill also restricts eligibility by expanding the definition of income to include nontaxable Social Security benefits, child support payments, nontaxable pension income and tax-exempt interest. We would have serious concerns about imposing an additional tax on Social Security benefits of taxpayers who qualify for the EITC.

The tax system does not count child support as income to the custodial parent, because child support payments are a continuation of the other parent's obligation to support his or her child. Custodial parents should be encouraged to seek child support, rather than being penalized for obtaining it. Moreover, this change would be extremely difficult for the IRS to administer, because it does not currently receive information about child support payments.

The administration is committed to improving compliance with the EITC. Its significant actions in the last 2 years are clear evidence of this strong commitment. The compliance problems which the administration is addressing should not be used as an excuse to eliminate or reduce the EITC to millions of low-income working Americans who are playing by the rules.

Finally, my written statement contains additional areas of possible improvement we would like to explore with the Subcommit-

tees.

Madam Chair, this concludes my remarks. Thank you. [The prepared statement and attachments follow:]

STATEMENT OF LESLIE B. SAMUELS ASSISTANT SECRETARY (TAX POLICY) DEPARTMENT OF THE TREASURY BEFORE THE

SUBCOMMITTEES ON OVERSIGHT AND HUMAN RESOURCES COMMITTEE ON WAYS AND MEANS UNITED STATES HOUSE OF REPRESENTATIVES

Chairman Johnson, Chairman Shaw, and Members of the Subcommittees:

I am pleased to have the opportunity to discuss the targeting and labor market effects of the earned income tax credit (EITC), as well as steps that are being taken to improve the credit. While I will briefly touch upon compliance issues, Commissioner Richardson's testimony will address administrative matters more completely.

The Administration is strongly committed to the goals of the EITC which are to make work pay and to lift workers out of poverty in the most efficient and administrable manner possible. Since the EITC was created in 1975, bipartisan support for the tax credit and its goals has been growing. With its message of "work pays," the EITC helps reduce dependency on welfare and increase reliance on jobs. Prior to 1993, Congress voted to significantly expand the EITC in the Tax Reform Act of 1986 and the Omnibus Budget Reconciliation Act of 1990.

This Administration's commitment to the EITC has been demonstrated through a number of legislative and administrative actions since early 1993. In February 1993, we proposed an expansion of the EITC in order to improve its effectiveness in encouraging work and increasing the disposable income of working families. With certain modifications, Congress enacted the Administration's proposals as part of the Omnibus Budget Reconciliation Act of 1993 (OBRA 1993). The EITC is growing as it was designed to grow pursuant to the three expansions signed into law by Presidents Reagan, Bush, and Clinton respectively. As soon as those expansions are fully phased in, the EITC costs will grow at a slower rate than gross domestic product (Figure 1).

Since the passage of OBRA 1993, we have proposed further legislative changes to improve the administration and targeting of the EITC, while reducing its costs. Four of these proposals were included in the Uruguay Round Agreement Act of 1994 (URAA). As a consequence of that legislation, the EITC is denied to nonresident aliens and prisoners, taxpayers are required to provide a taxpayer identification number for each EITC qualifying child regardless of age, and the Department of Defense is required to report to both the IRS and military personnel the non-taxable earned income used in computing the EITC.

In this year's budget, we proposed that the EITC be denied to taxpayers with \$2,500 or more of interest and dividend income. A similar, but modified, provision was included in H.R. 831, which extended and expanded the 25 percent deduction for health insurance costs incurred by self-employed individuals.

We have also made several proposals which are still pending final legislative action. This year's budget includes proposals to deny the EITC to undocumented workers and to provide the IRS with the authority to use simpler and more efficient procedures when taxpayers fail to supply a valid social security number. In addition, the Administration proposed legislation last year that would permit demonstration projects to test alternative methods of administering advance payments of the EITC. We hope that Congress will act on these outstanding proposals.

As Commissioner Richardson will testify, the Administration has taken other significant actions to strengthen the integrity of the EITC. We have expanded our outreach efforts to ensure that eligible low-income individuals are aware of the EITC and the advance payment option. We have also conducted studies of EITC compliance and the broader issue of problematic refunds. Last spring, then-Secretary Bentsen appointed a Task Force to conduct an independent investigation of the refund fraud, and Under Secretary Noble presented their interim findings and call for aggressive action to the Ways and Means Oversight

Subcommittee last October. This year, we have intensified our scrutiny of returns claiming the EITC in order to prevent erroneous refunds from being paid to ineligible individuals.

While the House budget resolution does not assume reductions in the EITC, we understand that members of the Subcommittees are concerned about the effectiveness of this tax provision. Moreover, the Senate has assumed that the EITC would be reduced in its budget resolutions. We are concerned that many of the proposals that have been discussed in the Senate to change the EITC, though described as compliance measures, would not reduce error rates. Rather, these proposals would simply raise taxes on low and moderate-income working families. In fact, some alternative proposals to redesign the EITC would actually cause both non-compliance and work disincentives to increase. Before considering significant changes to this important tax credit which rewards work, we would urge the Congress to wait, as is assumed in the House budget resolution, until we have had time to observe the effects of both recent legislation and our enhanced compliance efforts.

In the remainder of my testimony, I will discuss in some detail the goals of the EITC and the actions taken by the Administration to strengthen the effectiveness of the EITC, as well as our views regarding proposals for possible modifications to the EITC.

Description of Earned Income Tax Credit for Low-Income Workers

The EITC is a refundable tax credit that is available only to low and moderate income workers who have earned income and meet certain adjusted gross income (AGI) thresholds. To be eligible for the EITC, a taxpayer must reside in the United States for over six months. Nonresident aliens are not entitled to the EITC beginning in 1995.

The amount of the credit increases significantly if an individual has one or two qualifying children. A child qualifies a filer for a larger EITC by meeting relationship, residency, and age tests. To meet the relationship test, the individual must be a child, stepchild, descendent of a child, or foster child of the taxpayer. The child must generally reside with the taxpayer in the United States for over half the year. For foster children, the residency test is extended to the full year. A qualifying child must be under the age of 19 (24 if a full-time student) or be permanently and totally disabled. By tax year 1997, a taxpayer must provide a taxpayer identification number (TIN) for each qualifying child.

Computation of the Credit. The credit is determined by multiplying an individual's earned income by a credit percentage. For a family with only one qualifying child, the credit percentage for 1995 is 34 percent. The credit amount increases as income increases, up to a maximum income threshold. For 1995, the income threshold is \$6,160. Therefore, if there is only one qualifying child, the maximum credit for 1995 is \$2,094 (34 percent of \$6,160).

The credit is reduced and eventually phased out once AGI (or, if greater, earned income) exceeds a certain phase-out threshold. For 1995, the phase-out threshold is \$11,290. The phase-out is accomplished by reducing the credit by a phase-out percentage. In 1995, for a family with only one qualifying child, the credit is reduced by an amount equal to 15.98 percent of the excess of AGI (or, if greater, earned income) over \$11,290. The credit is completely phased out and is no longer available to taxpayers with incomes above the end of the phase-out range. In 1995, this income level is \$24,396. The income thresholds for both the phase-in and phase-out ranges are adjusted for changes in the cost of living.

If there are two or more qualifying children, the credit percentage, income thresholds, and phase-out percentage are higher. For 1995, the credit percentage for families with two or more children is 36 percent of the first \$8,640 of earned income. Filers with earnings between \$8,640 and \$11,290 are entitled to the maximum credit of \$3,110 (36 percent of \$8,640).

The phase-out percentage for these families is 20.22 percent. As in the case of the credit for families with one child, the credit is phased out starting at \$11,290. However, the phase-out range for families with two or more children extends to \$26,673.

In 1996, the credit percentage for families with two or more children will increase to 40 percent of the first \$8,900 of earnings. Filers with earnings between \$8,900 and \$11,620 will be entitled to the maximum credit of \$3,560 (40 percent of \$8,900). The phase-out percentage will also increase to 21.06 percent, and the phase-out range will extend to \$28,524. Thereafter, the income thresholds for both the phase-in and phase-out ranges will be adjusted for changes in the cost of living. (The dollar amounts shown for 1996 are estimates.)

Workers who do not reside with qualifying children may claim the EITC if they are between 25 and 64 years of age and are not claimed as a dependent on another taxpayer's return. For these workers, the basic credit is 7.65 percent of the first \$4,100 of earned income for a maximum credit of \$314. In 1995, the phase-

out range for these workers is between \$5,130 and \$9,230 of AGI (or, if greater, earned income). The phase-out percentage is also 7.65 percent. The income thresholds for both the phase-in and phase-out ranges are adjusted for changes in the cost of living.

Advance Payments of the EITC. There are two ways to receive the EITC. Individuals can claim the credit by completing a Schedule EIC when filing their tax return at the end of the year. Alternatively, individuals with qualifying children may elect to receive a portion of their EITC in advance by filing a Form W-5 with their employer. These individuals are entitled to receive on an advance basis up to 60 percent of the credit allowable for a family with one qualifying child. The employer is not required to verify a person's eligibility for the credit.

At the end of the year, the employer notifies both the IRS and workers of the actual amounts of advance credits paid to individual workers on the Form W-2. When filing tax returns at the end of the year, these workers reduce the amount of EITC claimed by the amount of advance payments received.

Questionable Claims: The IRS must follow normal deficiency procedures when investigating questionable EITC claims. First, contact letters requesting additional information are sent to the taxpayer. If the necessary information is not provided by the taxpayer, a statutory notice of deficiency is sent by certified mail, notifying the taxpayer that the adjustment will be assessed unless the taxpayer files a petition in Tax Court within 90 days. If a petition is not filed within that time and there is no other response to the statutory notice, an assessment is made in which the EITC is denied.

Refundable Nature of Credit: The EITC offsets Federal taxes paid by low and moderate-income families. In recent discussions, there has been some confusion regarding the refundable nature of the EITC. In large part, this confusion appears to stem from the distinction between Congressional intent and budgeting conventions. Under conventional budget accounting practices, the EITC is shown in the budget as a reduction in taxes only to the extent to which it offsets a taxpayer's liability for taxes paid through the income tax system. This is because the EITC is claimed through the income tax system and as a practical matter, the credit can be most easily measured as an offset against the taxes paid through this system. Thus, under these conventions, about 23 percent of EITC costs in FY 1995 are shown in the budget as a reduction in Federal income taxes and other taxes paid through the income system, including self-employment taxes (SECA). About half of EITC recipients have an income or SECA tax liability prior to the receipt of the EITC.

Given that the EITC was created to offset the tax burden of low and moderate-income families, the EITC should not simply be measured as an offset to income and SECA taxes. When the reduction in the employee and employer portions of all social security taxes are included in the calculation, about 78 percent of EITC costs offset individual income and payroll taxes paid by recipients. Nearly all EITC recipients are subject to either individual income or social security taxes before qualifying for the EITC. Even this measure does not take into account other taxes which are offset by the EITC. During the consideration of both OBRA 1990 and 1993, the EITC expansions were also viewed as a way of offsetting the burden of increases in excise taxes, particularly the increases in the gasoline tax.

There has also been some confusion about the fact that most EITC recipients choose to claim the credit at the end of the year as a lump-sum payment rather than by adjusting their withholding or by taking advantage of the advance payment option. In that regard, EITC recipients are not very different from the majority of taxpayers who choose to receive a refund at the end of the year, rather than reduce their income tax withholding during the year. About 70 percent of non-EITC recipients receive an average refund of \$1,150 at the end of the year.

Goals of the EITC

In developing the Administration's agenda for the EITC, we have been guided by the three basic principles of tax policy: efficiency, fairness, and simplicity. Specifically, we have sought expansions and modifications to the EITC in order to achieve the following four goals:

- (1) to make work pay for those who might otherwise be on welfare;
- (2) to ensure that an individual who works full time throughout the year will not live in poverty;
- (3) to target benefits to those with the greatest needs while minimizing distortions; and
- (4) to make it easier for eligible individuals to claim the credit and for the IRS to verify their eligibility.

I would like to address each of these four goals in more detail.

For low-income families, the EITC <u>makes work pay</u> in two ways. Unlike many assistance programs for low-income families, the EITC is limited to working families. Moreover, the credit amount initially increases -- rather than decreases -- for each additional dollar of earnings. As a consequence, the EITC is

different from low-income assistance programs that are characterized by a reduction in benefits for each additional dollar of earnings. The EITC significantly increases the marginal return from working for both those who do not work at all and those who work less than full-time at minimum-wage jobs throughout the year.

The positive link between the EITC and work also helps offset the work disincentives created by other tax and transfer programs. Between 1983 and 1990, payroll taxes increased five times. Currently, workers are taxed at the combined employer and employee rates of 15.3 percent on the first dollar of earnings for the old-age, survivors, disability and health insurance (OASDHI) programs. Beyond a relatively low income health food stamp benefits are reduced by 24 cents for each additional dollar of earnings. The EITC, with its positive credit rate on low earnings, is the only benefit designed to help offset the marginal tax rates imposed by these other programs.

A person who works at a full-time job for the entire year should not live in poverty. As the EITC has increased in recent years, the minimum wage and other benefits received by low-income working families have declined in real value. Without an increase in the minimum wage, its real value in 1996 will decline to its lowest value in forty years. In addition, AFDC benefits are no longer provided for most families in which a mother works at least half-time. In the early 1970s, most states provided AFDC benefits as a wage supplement to a mother with two children whose earnings equaled 75 percent of the poverty level. Currently, only three states provide comparable benefits. In order to ensure that a family of four dependent on a full-time worker earning the minimum wage is lifted out of poverty, it would require a combination of food stamps, enactment of the President's proposal to increase the minimum wage, and implementation of the expanded EITC.

The benefits of the EITC should be targeted to families with the greatest needs and to those who can be best served by the positive incentives associated with the EITC. As a consequence, the credit rate is highest at very low earning levels, thus reaching individuals who are often making the critical step from welfare to work. Because larger families have greater needs than smaller families, taxpayers with two or more children are entitled to a larger EITC than taxpayers with one or no children.

Families with incomes slightly above the poverty level also require assistance. Wages have stagnated for many workers and declined markedly for low-wage workers. Between 1973 and 1993, real hourly wages of full-time male workers at the tenth percentile (that is, those whose wages are just above those of the lowest-paid 10 percent of workers) declined 16 percent, while real hourly wages at the median fell 12 percent. By providing the EITC to families with incomes of up to \$28,524 in 1996, the tax provision provides a cushion to protect moderate-income families from the effects of wage stagnation.

The EITC is designed to target assistance to the very neediest working families. We cannot target assistance to low-income families without causing marginal tax rates to increase for families with slightly higher income. However, we can seek to minimize such distortions.

The fourth goal of the EITC is simplicity and verification. If eligibility rules are simple, taxpayers can more accurately claim the EITC and avoid costly errors. With simple and verifiable eligibility rules, the IRS can also better ensure that the EITC is paid only to taxpayers who are eligible for the credit.

Simplicity is particularly important, because eligible individuals can claim the EITC directly when they file their tax return. It is likely that this simple application process has contributed to high participation rates among families eligible for the EITC. It has been estimated that between 80 and 86 percent of eligible persons claimed the EITC in 1990.

From the IRS's perspective, it is easier to verify eligibility for the EITC if the rules are simple. Moreover, because the IRS does not ordinarily interview EITC claimants, it is important that eligibility be based on criteria which can be verified as quickly as possible through independent reporting sources. Simplicity and verification prior to the payment of the EITC are key to the successful operation of the tax credit.

The Ways and Means Committee recognized the importance of the need for simplicity during consideration of OBRA 1990. At that time, data from the 1985 Taxpayer Compliance Measurement Program (TCMP) became available, showing an unacceptable number of erroneous EITC claims. In response, the tax-writing committees worked with the Bush Administration to address this problem. The simplification provisions contained in OBRA 1990 were a first step toward reducing EITC error rates. As described below, additional steps have been taken since 1990 to further reduce EITC error rates.

Legislative and Administrative Actions in 1993 and 1994

As I outlined in the beginning of my testimony, the Administration and Congress have taken a number

of important legislative and administrative actions during the past two years in order to improve the effectiveness and administration of the EITC. I would like to review with you our accomplishments during this period.

OBRA 1993. OBRA 1993 expands the EITC and makes the tax credit more effective in achieving its policy objectives.

First, OBRA 1993 increased the returns from working for those outside the workforce and for other very low-wage workers. For very low-wage workers without qualifying children, the EITC offsets the employee portion of the OASDHI tax. During the past decades, these workers had borne the full burden of increases in OASDHI taxes because they were not entitled to the EITC. For a family with one child, the credit rate for those with low earnings was increased by 11 percentage points from 23 percent to 34 percent. For a family with two or more children, the credit rate for those with earnings below \$8,900 in 1996 was increased by 15 percentage points from 25 percent to 40 percent. For low-wage workers with two or more children, the EITC will fully offset the combined employee and employer portions of the OASDHI taxes and the food stamp benefit reduction formula.

The OBRA 1993 expansion was also a critical step toward achieving the goal that a full-time worker should not live in poverty if he or she works throughout the year. In combination, a minimum wage job, food stamp benefits, and the EITC can lift a single parent with one or two children out of poverty. But, the income (including the EITC and food stamps and subtracting the employee portion of OASDHI taxes) of a family of four with only one full-time, minimum wage worker falls below the official poverty threshold. Prior to the passage of OBRA 1993, the poverty gap for a family of four would have been \$2,435 in 1996. The OBRA 1993 expansion significantly closes that gap. However, since the minimum wage has not kept pace with inflation, the job is not completed yet. This is why the President has proposed that the minimum wage be increased over two years by 90 cents.

OBRA 1993 reduced the poverty gap for minimum wage workers by increasing the maximum benefits by nearly \$1,500 in 1996 for a family with two or more children. For these families, this increase in the maximum credit, without a change in the phase-out range, would have resulted in a phase-out rate of 30 percent. In OBRA 1993, we tried to find a balance between the goals of providing low-income families with sufficient income support, while minimizing the marginal tax rates placed on families with higher, but still modest, levels of income.

Thus, the increases in the maximum credit were accompanied by changes in the income thresholds. For all families with children, the beginning of the phase-out range was lowered by about \$1,600. As a consequence, the phase-out rate actually fell slightly for a family with one child since the end of the phase-out range was left unchanged. To reduce marginal tax rates among families in the phase-out range, eligibility for the EITC was extended to families with two or more children that have incomes in 1996 of up to \$28,524 (or about \$3,000 above the prior level). The combination of these factors increased the phase-out rate from 17.86 percent to 21.06 percent, rather than 30 percent.

While the effect of OBRA 1993 can not be measured yet, we believe that the legislation will, on net, increase work effort. While some workers with larger families will face slightly higher marginal tax rates, they are unlikely to change their behavior much in response. These are individuals who are already very attached to the work force. They cannot easily adjust their hours of work in response to a small change in tax rates: they need both their jobs and the EITC to meet their day-to-day needs, and most employers will not allow them the discretion to work fewer hours. The effect of the higher marginal tax rates on some workers in the phase-out range will likely be far outweighed by the effect of the increase in the credit rate. By making work pay, the OBRA 1993 increase in the credit rate will encourage non-workers to enter the workforce and other low-income part-time workers to increase their hours of work.

Finally, OBRA 1993 simplified the eligibility criteria for the EITC beginning in 1994 by eliminating the two supplemental credits for health insurance coverage and for taxpayers with children under 1 year of age. These two supplemental provisions added several paragraphs to the instructions, 10 additional lines on the Schedule EIC, and two additional look-up tables. The IRS could not easily verify eligibility for the supplemental credits because it did not receive independent verification of taxpayers' eligibility for them. These changes should improve compliance by reducing errors and improving verification.

URAA. URAA contains several provisions to improve the targeting of the EITC to those with the greatest need. Under this legislation, nonresident aliens are denied the EITC beginning in 1995. Under prior law, nonresident aliens could receive the EITC based on their earnings in the United States, even though they were not required to report their world-wide income to the IRS. Thus, it was possible for a wealthy foreign student to obtain the EITC based on his or her earnings as a teaching assistant at an American university.

In addition, prisoners will not be eligible for the EITC based on their earnings while incarcerated.

In the past, prisoners generally would not have been able to craim the EITC because they did not reside with a qualifying child for over half the year. When the EITC was made available to workers without children in 1994, it became possible for prisoners to receive the EITC based on their earnings at prison jobs. Because this provision was made effective for tax year 1994, the EITC will not be paid to these individuals.

URAA also contained two provisions to improve the administration of the EITC. By 1997, taxpayers will be required to provide TINs for all dependents and EITC qualifying children, regardless of their age. By requiring EITC claimants to provide the TINs of all children, regardless of age, URAA improves the ability of the IRS to verify the eligibility of a taxpayer for the EITC.

Under the legislation, the Department of Defense is required to provide military personnel and the IRS with information regarding basic housing and subsistence allowances (or in-kind equivalents) and income excluded by reason of service in a combat zone. These changes will not increase their taxable income but will improve accuracy in reporting and verification of earned income. The savings from this provision are somewhat offset by another provision which extends EITC eligibility to military personnel stationed abroad.

Administrative Actions. The Administration has taken a number of steps to ensure that eligible individuals know about the EITC and the advance payment option. While many eligible persons receive the EITC, deever than 1 percent of EITC claimants receive the credit through advance payments. The reasons for the low utilization rate are not fully known. One possible explanation is that workers simply do not know that they have the option of claiming the credit in advance. A General Accounting Office study in 1992 provided some support for this theory when investigators found widespread ignorance about the advance payment option among low-income workers.

The Administration has intensified its efforts to alert taxpayers of their eligibility for advanced payments. As one of the first steps, President Clinton announced a Federal campaign in 1994 to enroll eligible government workers in the advanced payment system. The Treasury Department and a group of business executives have also joined forces to encourage private-sector employers to notify their workers about the advanced payment option. As required by OBRA 1993, the IRS sends out notices to EITC claimants after the filing season, informing them about the advance payment option and (although not required by the 1993 legislation) also supplying a Form W-5 for their use:

As Commissioner Richardson will explain, the Administration has also taken steps to ensure that those who are not eligible for the EITC do not receive it. During a two-week period in January, 1994, the IRS conducted a pilot study to determine what additional enforcement tools might be necessary to detect and prevent erroneous refunds during the remainder of the 1994 filing season. The results of the pilot compliance study, drawn from a sample of over 1,000 taxpayers who filed electronically during a two-week period in January, 1994, found that about 26 percent of every dollar claimed in the EITC was in excess of the actual amount owed to the taxpayer.

The results of this pilot study are not representative of the EITC filing population as a whole. Nonetheless, the IRS has taken a number of responsible and needed steps to limit the EITC to those who are entitled to the credit. Beginning this year, the IRS is validating the social security numbers on all tax returns claiming the EITC. Refunds on returns with incorrect or missing numbers are being delayed while the IRS checks the accuracy of the refunds claimed. We estimate that the effects of the social security validation tests, along with conventional enforcement activities and the repeal of the complicated supplemental credits, should reduce the error rate to 19 percent.

Using the results of the pilot study and other information, the IRS is also increasing its screening and review of all returns to ensure that only those taxpayers entitled to refunds receive them. As a consequence, refunds may be delayed on other questionable returns. Moreover, other legislative steps, described above, are still being implemented over the next several years (e.g., the requirement that taxpayers provide a taxpayer identification number for all children regardless of age). Finally, Congressional action on the Administration's remaining legislative proposals, described below, should further reduce error rates. In combination, implementation of these additional enforcement procedures and legislative actions will make it more difficult for taxpayers to erroneously claim the EITC and further reduce error rates.

Finally, the IRS stopped providing Direct Deposit Indicators in the 1995 filing season to lenders who were providing refund anticipation loans. This action is also expected to reduce compliance problems that were associated with refund anticipation loans. The IRS's actions this filing season have been applauded as both responsible and necessary by Ways and Means Oversight Subcommittee Chairman Johnson and Ranking Member Matsui in a recent "Dear Colleague" letter to House members.

¹ U.S. General Accounting Office. <u>Farned Income Tax Credit: Advance Payment Option</u> is Not Widely Known or Understood by the Public. (GAO/GGD-92-26, February 19, 1992).

FY 1996 Budget Proposals

The Administration included several proposals to improve the targeting and administration of the EITC in this year's budget submission. We are ready to work with the Congress on those proposals which have not yet been enacted.

Deny EITC to taxpayers having more than \$2,500 of taxable interest and dividends. Under this proposal, the EITC would be denied to taxpayers having more than \$2,500 of taxable interest and dividends beginning in 1996. This threshold would be indexed for inflation thereafter.

This proposal would improve the targeting of the EITC to the families with the greatest need. Under current law, a taxpayer may have relatively low earned income and be eligible for the EITC, even though he or she has significant interest and dividend income. Most EITC recipients do not have significant resources and must rely on their earnings in order to meet their day-to-day expenses, but taxpayers with significant interest and dividend income can draw upon the resources that produce this income to meet family needs.

This proposal, with some modification, was included in H.R. 831, which extended and expanded the 25 percent health insurance deduction for self-employed individuals. H.R. 831 lowered the asset income threshold to \$2,350 and expanded the categories of income subject to the threshold to include tax-exempt interest and net positive rents and royalties. The asset income threshold is not indexed.

In developing the Administration's proposal, we considered a broader list of asset income subject to the cap. We recognized that a broader list might increase equity, by treating the recipients of certain other types of asset income in the same manner as those who receive interest and dividend income. An expanded list would also reduce the incentive to choose a particular type of investment based on its tax or refund consequences. However, we were also concerned because the inclusion of net positive rents and royalties would add complexity to the determination of the EITC. These items are not reported separately on the Form 1040. We did not include the broader list of asset items because we were also concerned that low-income taxpayers could not convert real estate holdings and other types of assets into cash as easily as savings accounts and stocks in a time of need.

While we did not oppose the inclusion of tax-exempt interest and net rents and royalties in H.R. 831, we are very concerned about the asset income threshold not being indexed. We believe that the asset income threshold should be indexed in the same manner as all other income parameters for the EITC. Without indexation, the number of persons affected by this provision will increase over time. By 2000, the threshold would be equal to about \$2,075 in 1996 dollars and would increase the number of affected taxpayers from about 550,000 to 650,000.

EITC Compliance Proposals. Under this budget proposal, only individuals who are authorized to work in the United States would be eligible for the EITC beginning in 1996. Taxpayers claiming the EITC would be required to provide a valid social security number for themselves, their spouses, and their qualifying children. Social security numbers would have to be valid for employment purposes in the United States. Thus, eligible individuals would include U.S. citizens and lawful permanent residents. Taxpayers residing in the United States illegally would not be eligible for the credit.

In addition, the IRS would be authorized to use simplified procedures to resolve questions about the validity of a social security number. Under this approach, taxpayers would have 60 days in which they could either provide a correct social security number or request that the IRS follow the current-law deficiency procedures. If a taxpayer failed to respond within this period, he or she would be required to refile with correct social security numbers in order to obtain the EITC.

In combination, these provisions would strengthen the IRS's ability to detect and prevent erroneous refunds from being paid out. In addition, the proposals would improve the targeting of the EITC by providing the credit only to individuals who were authorized to work in the United States.

<u>Tax Systems Modernization</u>. The budget submission for the IRS contains funding for the continuation of its tax systems modernization (TSM). We urge the Congress to continue to fund TSM. TSM is vital to the long-run efficiency of the IRS's collection functions. TSM will also enhance the IRS's ability to detect erroneous EITC claims.

Demonstration Projects Proposal

In June 1994, the Administration introduced the Work and Responsibility Act (H.R. 4605). One of the provisions in H.R. 4605 would provide additional flexibility to States with respect to the EITC. We continue to support this proposal.

The proposal would allow four demonstration projects to determine the effects of alternative methods of delivering advance payments of the EITC. States would apply to the Department of the Treasury to provide advance payments of the EITC directly to eligible residents through a State agency. Such agencies could include food stamp offices, Employment Services, and State revenue departments. State plans would be required to specify how payment of the EITC would be administered. To finance these payments, States would reduce payments of withholding taxes (for both income and payroll taxes) from their own employees by the amount of the advance payments made during the prior quarter. The four selected projects could operate for three years beginning in 1996.

This pilot program is designed to determine whether another approach would be more effective for delivering advance payments than the current employer-based system. For example, a State could choose to allow all eligible EITC recipients to apply for advance payments. By receiving the credit as they earn wages, workers would observe the direct link between work effort and the EITC. Through a State program, individuals could have a choice of receiving the credit from a neutral third-party, without fear of the consequences of notifying their employers of their eligibility for the EITC. Moreover, they could receive assistance in determining the appropriate amount of the EITC to claim in advance.

A State could instead choose to target the advance payments of the EITC to welfare recipients -- as a way of driving home the message that "work pays." These individuals may not kn in about the EITC, and how it can "make work pay," because they do not have to file a tax return if their adjusted gross incomes are below the tax thresholds (which are generally less than the poverty thresholds).

If the legislation passes, we will evaluate these demonstration projects in order to understand better how individuals respond to receiving advance payments of the EITC. We will pay careful attention to whether the use of State agencies can increase both utilization of the advance payment system and labor force participation by non-workers.

States also have the resources to verify many of the eligibility criteria for the credit better than employers, reducing the risk of erroneous payments being made to ineligible persons. This option would also allow for an evaluation of alternative delivery systems on compliance.

Other Suggestions

The Administration evaluates other proposals to modify the EITC by the same criteria we apply to our own proposals:

- (1) Does the proposal make work more attractive to those outside the workforce and to others with minimal ties to the workforce?
- (2) Does the proposal reduce the poverty gap for full-time workers?
- (3) Does the proposal improve the targeting of the EITC to the needlest individuals and families in the least distortionary manner? and
- (4) Does the proposal make it easier for eligible taxpayers to accurately claim the EITC and for the IRS to verify their eligibility before refunds are paid out?

We are concerned that many of the options that may be considered by the Subcommittees do not meet these criteria.

1. Senate Budget Committee Resolution

The Senate budget resolution assumes that the Senate Finance Committee will reduce the EITC by \$13 billion between FY 1996 and 2000 and \$21 billion between FY 1996 and 2002. The resolution further assumes that these savings can be achieved by repealing the EITC for workers without qualifying children, reducing the EITC rates for families with children, and adopting the Administration's EITC compliance proposals from the FY 1996 budget. Under the resolution, the credit rate for a family with two or more children would be reduced from its 1995 level of 36 percent to 35 percent. In addition, the credit rate for families with one child would be reduced from 34 percent to 30.15 percent. According to Treasury's estimates, the EITC proposals in the Senate budget resolution would reduce the EITC by \$16.6 billion over the next five years and \$25.6 billion over the next seven years. The Senate budget resolution would reduce the EITC for 14 million working families, on average, by about \$239.

These proposals would generally limit the effectiveness of the EITC in reducing poverty. For example, in 1996, the maximum EITC for families with two or more children is scheduled to increase from \$3,110 to \$3,560. This is the level necessary, in combination with a 90 cent increase in the minimum wage, to close the poverty gap for a full-time minimum wage worker who supports a family of four. Under the Senate budget resolution, the maximum credit would be \$445 less than current law.

By lowering the credit rate for families with children, the proposal also reduces the effectiveness of

the credit for encouraging work effort. Under the proposal, many EITC recipients with earnings of less than \$8,900 could receive a smaller EITC than in 1995. The reductions in the credit rate would also adversely affect those who are currently outside the workforce, but who are choosing between work and welfare.

The Treasury Department estimates that 14 million EITC recipients would have their taxes raised by these proposals. Of these 14 million, 10 million would be workers with children. About 8 million EITC recipients with two or more children would lose, on average, \$305 in 1996. About 2 million very low-wage workers with only one child would lose, on average, \$137 relative to current law. (See Figure 2 and attached table.)

The budget resolution also assumes the repeal of the EITC for 4 million very low-wage workers who do not reside with qualifying children. The OBRA 1993 expansion of the EITC for these workers was designed to help offset the work disincentive effects of the social security tax. If repealed, these workers will lose up to \$324 in 1996. At the poverty level (\$8,200 in 1996 for a single individual under age 65), a single taxpayer would have a combined income and social security tax liability of \$1,394 (including \$240 of income tax liability prior to the receipt of the EITC and including both the employee and employer portions of social security taxes). Under the proposal, this taxpayer's tax liability would increase by \$101. On average, low-wage workers who do not reside with qualifying children would incur a tax increase of about \$173 in 1996.

2. S. 899

Last week, Senators Roth, Nickles, and Pressler introduced a bill (S. 899) to reduce the EITC. S. 899 adopts many of the proposals assumed in the Senate budget resolution. However, it would reduce the EITC far more deeply than was considered in the resolution. According to Treasury estimates, S. 899 would reduce the EITC by \$37 billion between FY 1996 and 2000 and \$66 billion between FY 1996 and 2002.

Under S. 899, indexation of the EITC would be repealed. As a consequence of the repeal of indexation and the lowering of the credit rates, EITC recipients would be entitled to a maximum tax credit of \$3,024 in 1996, a reduction of \$536 relative to current law. The maximum tax credit amount would not change after 1996. By 2000, the maximum credit amount would be reduced by \$1,016 -- or 25 percent -- relative to current law.

Indexation is necessary to ensure that taxpayers do not lose eligibility for the EITC. Under current law, an estimated 16.7 million taxpayers with children will claim the EITC in 1996. If benefit thresholds are not adjusted for inflation, participation would shrink to 14.8 million by 2000.

Eliminating indexation does not address the issue of non-compliance at all. Instead, it denies eligibility and reduces the EITC for millions of taxpayers who work hard, pay their taxes, and play by the rules. A number of tax provisions are indexed for inflation each year. These include the personal exemption, standard deduction amount, the width of the income tax brackets, the phase-out ranges for the personal exemption and deduction amounts, and the social security earnings ceiling. It is inappropriate to suspend indexation on the one provision which is solely targeted to low-income taxpayers.

S. 899 would also limit eligibility for the EITC by adding new restrictions on the amounts and types of income held by recipients. The investment income cap would be lowered from \$2,350 to \$1,000. Net capital gains and passive partnership and estate income would also be added to the investment income cap. We would have serious reservations about lowering the investment income cap from \$2,350 to \$1,000.

The bill's sponsors argue that at prevailing interest rates, it is inappropriate to provide the EITC to taxpayers with assets which can generate a \$1,000 of investment income. While we agree that taxpayers with large amounts of assets should not receive the EITC, we view the \$1,000 investment income cap as too restrictive. Low and moderate-income families should be encouraged to save for down-payments on homes, start-up capital for businesses of their own, their children's education or their own retraining. For example, the median price for a home purchased in 1994 by a first-time homeowner was \$125,000, with an average downpayment of 13.7 percent of the price (or \$17,125), while the costs of a four-year education at a typical state university exceeded \$25,000. Under the proposal, the EITC would be denied to many families saving for these investments in their futures unless they liquidated their savings or shifted their investments to exempted assets.

- S. 899 would also restrict eligibility for the EITC by expanding the definition of income. For purposes of determining eligibility for the EITC, adjusted gross income would be expanded to include non-taxable social security benefits, child support payments, non-taxable pension income, and tax-exempt interest. We are very concerned about proposals to expand adjusted gross income to include these items.
- S. 899 would effectively impose an additional tax on social security benefits of taxpayers who qualify for the EITC. The EITC would be reduced by up to 20 cents for each additional dollar of social security

benefits. Low-income elderly workers with children could be subject to higher taxes on social security benefits than some of their better-off neighbors. In part, a portion of workers' social security benefits (as well as non-taxable pension income) represent the return of their own contributions from previously taxed income. The proposal could affect non-elderly workers with young children, too. The EITC would be reduced or eliminated for a low-wage worker whose disabled spouse receives disability insurance benefits. Reducing the EITC benefits of social security recipients could also compound the work disincentives already present in the social security programs.

The tax system does not count child support as income to the custodial parent because child support payments are a continuation of the other parent's obligation to support his or her child. Custodial parents should be encouraged to seek child support, rather than being penalized for obtaining it. As a result, we have serious reservations about this provision as well. This provision would also add complexity to the determination of EITC eligibility and would be difficult to verify. In particular, the IRS does not currently receive information about child support payments.

In combination, these proposals would raise taxes on 19 million taxpayers, on average, by \$602 in 2000 (measured at 1996 income levels). Taxpayers with two or more children would be most adversely affected by these provisions. For eight million taxpayers with two or more children, the EITC would be reduced, on average, by \$886 in 2000 (measured at 1996 income levels).

The Administration is committed to improving compliance with the EITC rules. Its actions in the last two years are clear evidence of this commitment. The compliance problems which the Administration is addressing should not be used as an excuse to eliminate or reduce the EITC to all low-income working people. Consequently, the Administration strongly opposes proposals to eliminate indexation or to add complexity to the EITC eligibility criteria.

3. New Initiatives

The Administration is committed to taking additional steps to improve the administration of the EITC beyond the steps which have been taken or proposed in this year's budget. We would be particularly interested in exploring with Congress legislative proposals to improve the ability of the IRS to verify eligibility for the EITC.

First, we are announcing our intention to send to Congress a new legislative proposal which would provide the IRS with additional authority to prevent the payment of problematic refunds. We will propose that the IRS be authorized to use simplified procedures to reduce the amount of a taxpayer's EITC by the amount of unpaid self-employment taxes shown, either directly or indirectly, as being due with the return. Under this approach, taxpayers would have 60 days in which they could either demonstrate that they did not owe social security taxes on reported income or request that the IRS follow the current-law deficiency procedures. If a taxpayer failed to respond within this period, he or she would be required to refile with correct information on earnings and social security tax liabilities in order to obtain the EITC.

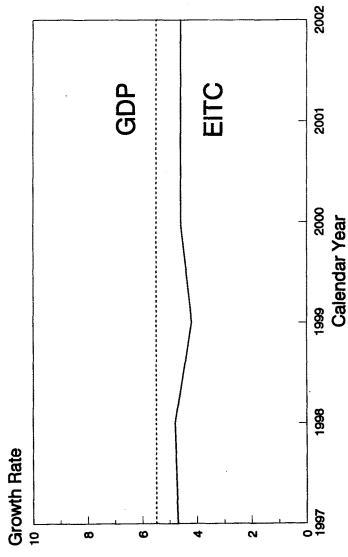
This proposal will ensure that taxpayers pay social security taxes on self-employment income which is also applicable toward their EITC. This proposal would reduce the incentive for taxpayers to over-state income in order to appear eligible for a larger EITC. While there is no conclusive evidence at this time of widespread EITC abuse by self-employed taxpayers, we recognize that the credit structure could lead to such problems in the future. This proposal is designed to deter this potential problem. We will also continue to carefully monitor this issue to determine the scope and nature of any potential or actual abuse.

Second, we are beginning a study to examine the benefits and costs of improving information-sharing between the IRS and States. The study will build on existing IRS efforts to improve information-sharing with State agencies. For example, during the past year, the IRS has been working with the State of California to determine whether wage data from the unemployment compensation system can assist the IRS in validating EITC claims. The new study will examine whether information from State welfare agencies would be useful in determining whether an EITC qualifying child was claimed by the appropriate taxpayer. The study will determine if State data can be made available to the IRS in a timely and consistent manner, and whether changes in disclosure laws are required to facilitate data exchange.

We would also like to explore with the Subcommittees other options for improving the administration of the EITC. For example, reporting requirements for non-taxable earned income, which is used in the calculation of the EITC, could be enhanced.

This concludes my remarks. Thank you once again for providing me with the opportunity to testify. I would be pleased to answer any questions that the Subcommittees may have.

Figure 1: Growth in the EITC and GDP* 1997 - 2002



*Under current law and Administration's January budget assumptions

Figure 2: The Earned Income Tax Credit, 1995

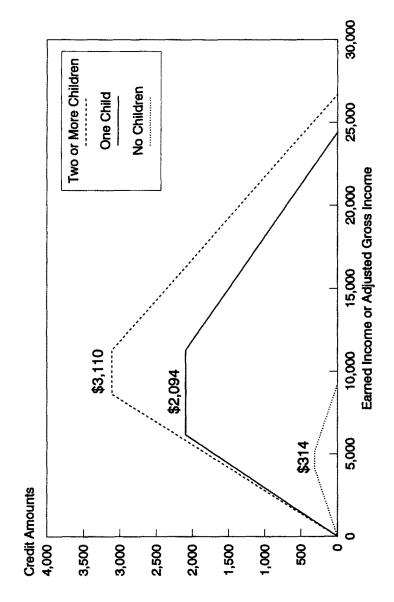


Figure 3: The Earned Income Tax Credit, 1996

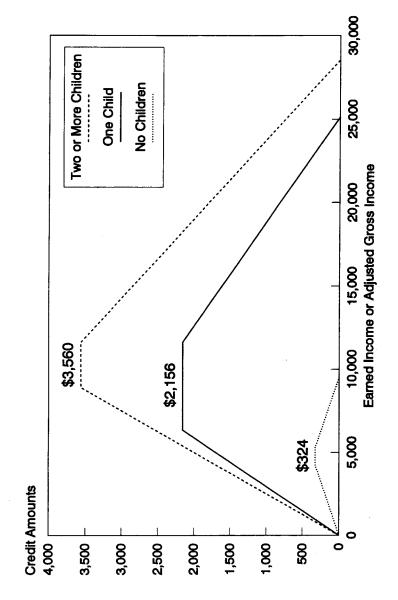


Figure 4: The Earned Income Tax Credit Under OBRA 1990 and OBRA 1993, Fully Phased In

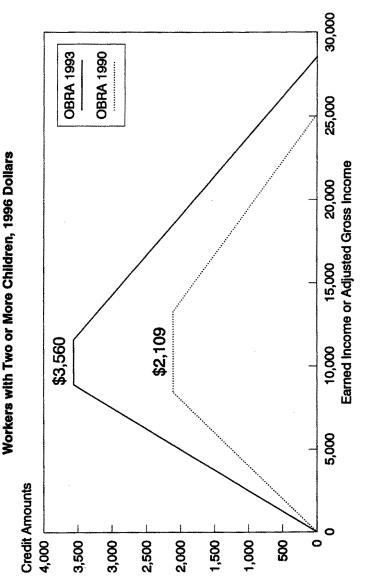
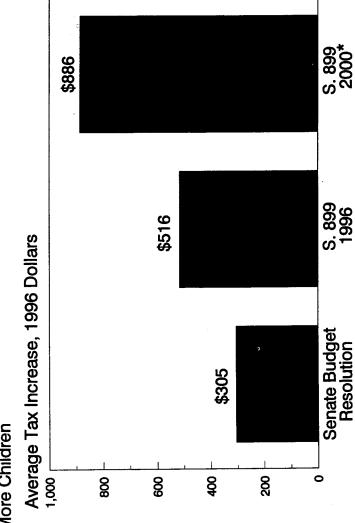


Figure 5: Effect of Senate Proposals on EITC Recipients with Two or More Children



*Estimate reflects effects of deindexation by the year 2000, estimated at 1996 income levels.

Effect of Senate Proposals on EITC Recipients 1996 Income Levels

Senate Senate S. 899

Budget 1996 2000 *

Total EITC Recipients			
Number of Affected Taxpayers	14 million	19 million	19 million
Average Tax Increase	\$239	\$ 311	\$602
Taxpayers with Two or More Qualifying Children			
Number of Affected Taxpayers	8 million	8 million	8 million
Average Tax Increase	\$305	\$516	\$886
Taxpayers with One Qualifying Child			
Number of Affected Taxpayers	2 million	7 million	7 million
Average Tax Increase	\$137	\$166	\$563
Taxpayers without Qualifying Child			
Number of Affected Taxpayers	4 Million	4 Million	4 Million
Average Tax Increase	\$173	\$173	\$173
Department of the Treasury Office of Tax Analysis			June 12, 1995

* Estimate reflects effects of deindexation by the year 2000, estimated at 1996 income levels.

Chairman JOHNSON. Thank you. Commissioner Richardson.

STATEMENT OF HON. MARGARET MILNER RICHARDSON, COM-MISSIONER, INTERNAL REVENUE SERVICE; ACCOMPANIED BY TED BROWN, REFUND FRAUD EXECUTIVE, IRS

Ms. RICHARDSON. Madam Chairman, Mr. Chairman and the distinguished Members of both Subcommittees, I want to thank you for the opportunity to be here today to discuss the IRS' efforts to improve the administration of the EITC.

When I became Commissioner a little over 2 years ago, I recognized the need to improve the administration of the EITC to ensure that it was available only to those working Americans who earned

it.

As Assistant Secretary Samuels has stated, legislation that was recently enacted will improve the EITC's effectiveness. The administration has also submitted additional legislative proposals—and another one which was mentioned by Mr. Samuels today—which would aid very much in the administration of the EITC.

In addition to these important legislative initiatives, beginning with the 1994 filing season and continuing through this filing season, the IRS has taken several steps to improve the administration of the EITC. A preliminary analysis of the returns that have been filed so far this year indicates that our efforts have paid off.

This morning, I would like to describe for you what we have done this filing season to improve EITC compliance and to tell you about

our future plans.

As part of our continuing efforts to improve compliance, the IRS implemented numerous systemic verifications and enhancements for the 1995 filing season. These initiatives include the increased verification of taxpayer SSNs, additional checks of returns claiming refundable credits, including the EITC, and increased compliance resources devoted to preventing and detecting erroneous and fraudulent refund claims before those claims were paid.

An important part of our strategy this year included delaying refunds that, as a result of computer analysis and fraud identification profiles, appeared on the surface to be erroneous. This additional time for review helped us check questionable claims and detect fraud schemes, including those schemes that employed dupli-

cate uses of SSNs.

During the filing season, the IRS devoted substantial resources to ensuring that taxpayers claiming refunds used the proper SSNs. We have been checking paper returns for missing, invalid or duplicate SSNs, and we have not been accepting electronically filed returns without correct, valid SSNs for the taxpayer, the taxpayer's spouse and for the dependents that were claimed. As of June 2, 1995, over 10 million missing, invalid or duplicate SSNs have been identified.

To further address noncompliance problems related to refundable credits, during this filing season we performed additional checks on returns claiming these credits to ensure that only those taxpayers who were entitled to them received them.

A preliminary analysis of the returns that have been filed so far this year does indicate that our efforts are paying off. As of May 26, the number of EITC claims by filers with qualifying children had decreased by 257,000 below last year. Prior to the 1994 tax year, EITC claims had increased each year since 1989. We believe that our efforts this filing season have kept those who had not earned the EITC from claiming it.

Also, through May 21 of this year, approximately 800,000 fewer dependents were claimed compared to that time last year. Thus, for the first time in several years, the number of dependents being

claimed did not increase.

The reduction in EITC claims and in the number of dependents is particularly significant, considering that the number of individual returns that were filed through May 26 is up over 1 million over this time last year.

In addition to enhancing our systemic filters to detect more questionable refund claims during this filing season, thanks to the additional compliance resource that Congress provided us this year, our 5-year compliance initiative, for the first time in a number of years we were able to substantially increase the enforcement resources dedicated to examining questionable claims, as well as to identifying fraudulent schemes.

Electronically filed returns that had duplicate SSNs were rejected. By rejecting these returns, erroneous claims and fraud schemes that in past years had made it into the system were kept out. In addition to the systemic screens, as of May 26, we had identified over 2,600 fraud schemes and we delayed \$65 million that had been claimed on over 46,000 electronic and paper returns.

Beginning last filing season and continuing this filing season, we have also delayed refunds with questionable EITC claims until those returns could be examined. As part of this initiative, from January 1994 through April 1995, 370,000 returns were examined and \$330 million in refunds were not paid because taxpayers were not able to verify that they were entitled to the EITC they claimed. As we continue the examinations of more than 700,000 EITC returns that are currently in our inventory, we would expect comparable results—EITC claimed in error never being paid.

Although the 1995 filing season is almost at an end, we have already begun planning our strategy to prevent all erroneous or fraudulent refund claims, including EITC claims, for next filing season. Information learned this filing season will be the basis for modifying and refining our current procedures. We will revise the standards for participation in the electronic filing program and adapt our fraud and error detection systems accordingly. If necessary, we will put in place new technology and additional filters.

The proposed legislation that is now pending would significantly aid our administration of the EITC because it would require EITC claimants to provide valid SSNs for themselves and their qualifying children, and it would permit us to treat an EITC claim the same way we do math errors when a Social Security number is either not provided or the Social Security number provided is not valid.

A similar procedure to the one currently used to correct math errors is appropriate and needed. Although we have the technological capability to identify returns without obvious mistakes, because the statutory deficiency procedures require multiple actions and are

more complex than math error procedures, we can only reach a

limited number of taxpayers with our current resources.

The proposed math error procedure would be used only in those instances where a taxpayer's EITC claim has not been substantiated by a valid SSN. Banks do not let their customers withdraw money without providing the necessary information, including an appropriate account number and a PIN, personal identification number. Congress should give us comparable tools.

Madam Chairman, Mr. Chairman, the IRS is committed to stopping EITC noncompliance, while at the same time ensuring that all hard-working Americans who earn the EITC receive it. The assistance of you and the Subcommittees in enacting the legislation that is pending would greatly assist our efforts to achieve these two im-

portant goals.

Thank you very much. This concludes my prepared remarks and I will be happy to answer any questions that you or your colleagues have

[The prepared statement and attachment follow:]

STATEMENT OF MARGARET MILNER RICHARDSON COMMISSIONER OF INTERNAL REVENUE BEFORE THE

SUBCOMMITTEES ON OVERSIGHT AND HUMAN RESOURCES HOUSE COMMITTEE ON WAYS AND MEANS

JUNE 15, 1995

Madame Chairman, Mr. Chairman and Distinguished Members of the Subcommittees:

I appreciate the opportunity to be here today to discuss the IRS's efforts to improve the administration of the Earned Income Tax Credit (EITC).

The BITC is a credit that is available only to low and moderate income workers who have earned income and meet certain income thresholds. The amount of the credit increases if the worker has one or two qualifying children. The EITC is designed to make work pay and to lift workers out of poverty in the most efficient and administrable manner possible. Since becoming Commissioner over two years ago, I recognized the need to improve the administration of the EITC and to ensure that the BITC is available only to those hard working Americans who have earned it.

To improve the BITC's effectiveness, in 1993, the Administration supported a proposal to simplify the credit by eliminating the two supplemental credits for health insurance coverage and for taxpayers with children under 1 year of age. The proposal was enacted as part of the Omnibus Budget Reconciliation Act of 1993. In the 1994 GATT legislation, the BITC was denied to nonresident aliens and prisoners. Taxpayers are required to provide a taxpayer identification number for each BITC qualifying child, regardless of age. Also, members of the Armed Forces stationed abroad are now eligible for the credit, and the Department of Defense is required to report to both the IRS and military personnel non-taxable earned income paid during the year that is included in computing the BITC.

The Administration has submitted additional legislative proposals which are still pending legislative action. The proposals include a provision that would deny the BITC to undocumented workers, and a provision that would authorize the IRS to use simpler and more efficient procedures when taxpayers claiming the BITC fail to supply valid social security numbers.

In addition to these important legislative initiatives that will aid in the administration of the EITC, the IRS, beginning with the 1994 filing season and continuing through this year's filing season, has taken several steps to improve the administration of the EITC. A preliminary analysis of returns filed so far this year indicates that our efforts have paid off.

This morning, I would like to share with you what the IRS has learned about BITC compliance, describe for you the IRS's actions during this filing season to improve BITC compliance, and discuss with you our future plans.

FILING SEASON STUDIES

During the 1994 filing season, as part of our efforts to gain a better understanding of the characteristics and extent of BITC compliance, the IRS performed a small study of electronically filed returns over a two week period. The study of 1059 returns selected in the last two weeks of January was designed to provide the information needed to put controls in place quickly for the rest of the 1994 filing season that would prevent and detect BITC compliance problems, including fraud. This study is now final, and a detailed report of this study is attached as an Appendix.

Information from this 1994 filing season study was used to develop additional controls to stop EITC noncompliance, including fraud, for the 1995 filing season. In addition, to expand our understanding of EITC compliance, we are conducting another study this year. This study involves a statistically valid, random sample of approximately 2,000 refund returns filed electronically and on paper throughout the 1995 filing season claiming the EITC.

Results from the 1995 study will be used to expand our understanding of issues identified during the first study. The field work and analysis of results will be completed this fall, and we will be pleased to share the results with the Subcommittees.

To improve compliance in all areas, including EITC, the IRS must continually assess emerging trends and constantly revise prevention mechanisms. Strategies, which are perfectly satisfactory today, may be useless tomorrow. The study of refund returns filed during this filing season will provide valuable information to better hone our strategy for next year's filing season and beyond.

FISCAL YEAR 1995 INITIATIVES AND RESULTS

As part of our continuing efforts to improve compliance, the IRS implemented numerous systemic verifications and enhancements for the 1995 filing season. These initiatives include increased verification of taxpayers' social security numbers (SSNs); additional checks of returns claiming credits, including the EITC; suitability checks and increased monitoring of Electronic Return Originators (EROs); and increased compliance resources devoted to preventing and detecting erroneous and fraudulent refund claims before the refunds are paid. In addition, an important part of our strategy included delaying refunds that, as a result of computer analysis and fraud identification profiles, appeared erroneous or perhaps fraudulent. This additional time for review helped us check questionable claims and detect fraud schemes, including duplicate uses of SSNs.

Closer Scrutiny Of Returns

Internal IRS studies and the report of an outside expert confirmed that erroneous or fraudulent refund claims, including EITC claims, often involved the use of incorrect or invalid SSNs.

As a result, during the 1995 filing season the IRS has devoted substantial resources to ensuring that taxpayers claiming refunds used the proper SSNs. A correct, valid SSN must be provided for the taxpayer, spouse, and dependents before an electronically filed return will be accepted. As of June 2, 1995, over 4.3 million occurrences (not returns) of missing, invalid, or duplicate SSNs have been identified on electronically filed returns resulting in the affected returns being rejected and, thus, prevented from entering the filing system electronically.

The checks of SSNs are not limited to electronically filed returns, however. We are also checking paper returns for missing, invalid, or duplicate SSNs. As of June 2, 1995, over 6.3 million SSN errors were identified on returns filed on paper which resulted in correspondence with the taxpayer and a delay of the refund.

We spent a lot of time both before and during this filing season urging taxpayers to use correct SSNs for themselves and their dependents. The importance of using accurate SSNs this filing season was emphasized in many ways, including a message to that effect on the cover of all tax packages and through many public announcements. Although the verification of SSNs caused delays for some taxpayers legitimately claiming refunds this year, once the SSN is corrected, these taxpayers should not experience delays in future years because of SSN problems.

To further address noncompliance problems related to EITC and other credits, such as motor fuel excise tax credits, during this filing season, we performed additional checks on returns claiming these credits to ensure that only those taxpayers who were entitled to such credits received them. On some returns, refunds were delayed to allow us additional time to verify claims prior to issuing the refunds.

At the beginning of this filing season, the IRS estimated that 82 million individual returns claiming refunds would be filed in 1995 and up to eight percent of these refunds could be delayed as a result of the screens and filters put into place. Through June 2, 1995, 79.2 million refunds have been issued -- 76 million were issued for the full amount of the refund; 3.2 million were partial refunds. Only 4.2 million refunds have been delayed in their entirety -- numbers that are consistent with our original estimates.

A preliminary analysis of returns filed so far this year indicates that our efforts to perform additional checks of refund claims and to verify SSNs have paid off. As of May 26, 1995, 17.3 million returns have been filed claiming the EITC. While the total number of EITC claims has increased by 3.2 million over last year, this increase is solely attributable to claims by filers without qualifying children who were first eligible to claim the EITC in 1994. If the BITC filers without qualifying children are disregarded, EITC claims have decreased by 257,000 from last year. We project that by the end of the filing season, EITC claims with qualifying children will decrease by 100,000 - 200,000 over last year. Because prior to the 1994 tax year, EITC claims had increased each year since 1989, it appears our efforts this filing season may have kept those who had not earned the BITC from claiming it.

Additionally, through May 21, 1995, the number of dependents claimed for tax year 1994 when compared to the number of dependents claimed in tax year 1993, (based on returns filed through the same period last year) has decreased by approximately 800,000. We believe that, if this pattern continues, when the 1995 individual returns have been filed (including extensions) either fewer dependents or no more than the same number of dependents will have been claimed for 1994 as were claimed in 1993. If so, this would be the first time in several years that the number of dependents being claimed did not increase. Our preliminary analysis shows that this result is probably due to the fact that non-existent or non-qualifying dependents claimed in prior years were not claimed this year. The reduction in EITC claims and in the number of dependents claimed is particularly significant when you realize that the number of individual returns filed through May 26, 1995 has increased over last year.

We at the IRS recognize that we must balance our efforts to detect and prevent BITC noncompliance with the need to ensure that those hard working Americans who are eligible for the EITC receive it. This filing season, although we performed additional checks to ensure fraudulent or incorrect claims did not get into the system, we also sent over 420,000 notices to taxpayers who appeared to qualify for the BITC but who had failed to claim it on their 1994 tax returns.

Our screens are designed to detect erroneous or suspicious returns. Unfortunately, some taxpayers who have filed complete and accurate returns also had their refunds delayed. We regret the inconvenience caused them, but I believe that most taxpayers want us to maintain the integrity of the tax system by making certain that only those who are entitled to refunds get them --even if additional time is needed to verify the accuracy of refunds claimed.

Enforcement Activities

In addition to enhancing our systemic filters in order to detect more questionable refund claims during the 1995 filing season, we substantially increased the enforcement resources dedicated to examining questionable claims as well as identifying fraudulent schemes. Criminal Investigation Division resources in our Questionable Refund Detection Teams were increased by 11 percent and Examination resources were increased by 277 percent - over 1,700 enforcement staffyears are being devoted to detecting and preventing refund fraud.

This filing season, electronically filed returns that had duplicate uses of SSNs for dependents and EITC qualifying children were rejected. By rejecting these returns, erroneous claims and fraud schemes that in past years made it into the system were kept out. In addition to these systemic screens, as of June 2, 1995, we had identified 2,685 fraud schemes, delaying \$65.9 million claimed on over 46,700 electronic and paper

Beginning last filing season and continuing this filing season, we have delayed refunds with questionable EITC claims until the returns can be examined. As a part of this initiative, from January 1994 through April 1995, 370,780 returns were examined. As a result of these examinations, \$330 million in refunds were not paid because taxpayers were unable to verify that they were entitled to the EITC claimed. As we continue the examinations of more than 700,000 additional returns with questionable EITC claims that are currently in the Examination Division inventory, we expect comparable results -- EITC claimed in error never being paid.

FUTURE PLANS

Although the 1995 filing season is almost at an end, under the direction of Mr. Brown, the Filing Fraud Executive, we have already begun planning our strategy to prevent all erroneous or fraudulent refund claims, including EITC claims, for next filing season.

Valuable information learned this filing season will be the basis for modifying and refining our current procedures. We will revise the standards used to screen EROs and adapt the systemic screens used to detect fraud and errors during this filing season; if necessary, we will put in place new technology and additional filters.

To identify more sophisticated fraud schemes, we are working with the Los Alamos National Laboratory to design software which detects anomalies and matches patterns in large data sets. Five new anomaly detection/pattern recognition tools have been tested at the Cincinnati Service Center this filing season. Preliminary results indicate that these tools will significantly enhance our ability to detect filing fraud schemes.

While we will continue to enhance our detection and prevention efforts, the key to improving our ability to detect increasingly sophisticated fraud schemes is our Tax Systems Modernization Program. Without modern technology -- hardware and software -- applying expert systems analysis to large databases is virtually impossible. Tax Systems Modernization will not only provide the computing power and capacity needed to apply sophisticated fraud detection systems, but, equally as important, it will also provide more timely access to information.

In addition to enhancing our technological capabilities, the Clinton Administration has proposed legislation to aid significantly our administration of the EITC and especially our efforts to improve EITC compliance. This legislation would require EITC claimants to provide valid SSNs for themselves and their qualifying children and permit the IRS to treat an EITC

claim in the same way it does math errors when an SSN is either not provided or the SSN provided is invalid.

Under current law, if the IRS detects an EITC claim with a missing or invalid SSN, before the refund claim is denied, it is subject to multiple actions under the statutory deficiency process, a process that typically takes about 8 months. The proposed procedure would authorize the IRS to recompute a taxpayer's tax liability if a tax return contains an EITC claim with a missing or invalid SSN. Before any adjustment is final, the IRS would send the taxpayer a notice asking for a correct SSN. If the taxpayer did not respond within 60 days (under statutory deficiency procedures taxpayers get two notices, a 30-day notice and a 90-day or statutory notice) the taxpayer's refund would remain adjusted.

A procedure similar to the procedure currently used to correct math errors is appropriate and needed. Although the IRS has the technological capability to identify returns with obvious mistakes, because the statutory deficiency procedures require multiple actions and are more complex than math error procedures, we can only reach a limited number of taxpayers with our current resources. The proposed math error procedure would be used only in those instances where a taxpayer's BITC claim has not been substantiated by a valid SSN. Banks do not allow their customers to withdraw money without providing all the necessary information, including an appropriate account number and a PIN. Congress should give the IRS comparable tools.

CONCLUSION

Madame Chairman, Mr. Chairman, the IRS is committed to stopping EITC noncompliance, while at the same time ensuring that all hardworking Americans who earn the EITC receive it. The assistance of you and your Subcommittees in enacting the Administration's proposals to aid in the administration of EITC would greatly assist our efforts to achieve these two important goals.

This concludes my prepared remarks. My colleagues and I would be happy to answer any question you or other Subcommittee members may have.

1994 Earned Income Tax Credit Compliance Study

I. Introduction

The Internal Revenue Service undertook this study early in the 1994 filing season in order to identify ways of reducing refund fraud associated with the Earned Income Tax Credit (EITC) during the remainder of the 1994 filing season. This information was also viewed as critical for designing new fraud control interventions for the 1995 filing season. Although the initial scope of the study was focused on identifying apparently fraudulent or intentionally overstated claims for EITC, it became evident that the results provided broader information on taxpayer understanding and compliance with EITC qualification requirements.

It is significant that this compliance study was the first of its kind conducted by the Service. As noted in the following sections, the validation of sampled EITC claims was very different from traditional IRS compliance measurement programs. Therefore, its unique character offers valuable information on taxpayer compliance but these "first-time" results provide limited comparability to previous studies because of the difference in methodology.

It is also important to understand that this study was never intended to provide an overall assessment or measurement of EITC compliance for the entire filing season. Because the study only included early filers on the electronic filing system, it cannot be interpreted as representative of all electronic filers or all paper filers claiming the BITC during the 1994 filing season. For this reason, the Service recognized the need to design a more comprehensive compliance study for the 1995 filing season. The 1994 study did not seek to measure or quantify "fraud" in the BITC, but sought to provide useful information about the types of errors or abuse that could be used by persons to file fraudulent or overstated claims with the IRS.

II. Sample Design

The study sample was drawn from tax returns claiming the EITC and filed electronically during two early weeks of the 1994 filing season (January 14 thru January 28, 1994). A computer program was written to select every 1,001st EITC return with the 517th return as the initial starting point for sampling in each of the five IRS processing centers that receive electronically filed returns. This systematic sampling procedure ensured that the number of returns sampled at each center would be approximately proportionate to their EITC filing volumes during the sampling period. In order to maintain geographic balance in the sample, the sampling rates were manually adjusted in some centers. This systematic method of sample selection was designed for simplicity.

The total sample selected was 1,068. During the field validation phase, additional cases were dropped from the sample. These deleted cases included returns where the BITC schedule was attached but no BITC amount was claimed, returns filed from overseas military addresses (FPO/APO), and returns where the taxpayer had died or could not be located. <1> The final sample count used for the analysis was 1,059.

<1> The cases that were dropped from the sample because the IRS could not locate the taxpayer were limited to situations where the taxpayer could not be located, nor could information on the return be confirmed or validated from other sources. In other cases that were retained in the sample, the taxpayer could not be located but information was validated by employers, preparers or other family members.

Returns that were filed electronically in the 1994 filing season were subject to a variety of validity and consistency checks before being "accepted" by the IRS. This included checking all Social Security Numbers (SSNs) listed on the return and matching the dependent's birth date to the Social Security Administration record. If any SSN was invalid, the return was rejected and could not be included in the sample. The sample included returns with "SSN applied for" for a child under one year of age.

As noted previously, this sample was not designed to provide representative data for all BITC filers during the 1994 filing season. However, to examine how the early electronic filers claiming the EITC differed from all EITC filers, data from the sample was compared to the Statistics of Income Sample of 1993 filers. (Table 1 summarizes this information.)

Sample period - Between January 14 and January 28, 1994, the electronic filing system accepted 1,273,000 tax returns claiming the BITC. The average BITC claimed was approximately \$1,163. Head of Household (HOH) claimants comprised about 78.8% of the total. Married Filing Joint (MFJ) filers accounted for 20% of the total and the remaining 1.3% were filed by Single filers with dependents.

Filing Season - For the 1994 filing season, 15,117,000 returns claiming BITC were filed according to the 1993 tax year Statistics of Income data. The average BITC claim was estimated to be \$1,025. HOH Filers represented 63.7% of BITC claimants, MFJ and Single filers accounted for 32.9% and 3.4% respectively.

The sampled BITC returns filed electronically during the last two weeks of January 1994 differed from BITC claims filed during the entire filing season in the following categories:

- -- During the filing season, 64% of EITC claimants are head of households, compared to 79% during the last two weeks of January.
- -- During the filing season, 13% of EITC filers claim Schedule C income. In the EITC study, only about 1% of filers claimed Schedule C income.
- -- During the filing season, about 15% of filers claiming the BITC have adjusted gross incomes below \$5,000. In the BITC study, about 8% of the sample have adjusted gross income below \$5,000.

III. Methodology for Determining Errors

- A. The initial step in building case files from the sampled returns was conducted in the service centers. Transcripts of the taxpayers' prior filings were obtained and associated with the sample return. The case file was then transmitted (usually within 3-5 days of the filing of the return) to a Special Agent (criminal investigator) for contacts to verify the EITC claim.
- B. The Special Agent assigned the sample return was required to contact the taxpayer, the electronic return originator/transmitter, the tax return preparer (if different from the electronic return originator) and, the employer (if W-2 wages were the source of EITC qualifying income). The agent was also instructed to contact other third parties if needed to validate the EITC claim. These contacts were made face-to-face at the residence or business location rather than requiring the taxpayer or witness to appear at IRS offices. The agent was required to complete his/her inquiries within seven days, so that the findings

could be used to make necessary changes in the 1994 questionable refund screening procedures. The agent tested the accuracy of qualifying earned and adjusted gross income, the filing status of the taxpayer and the existence and qualifications of qualifying children reflected on the EITC schedule. If the agent believed the claim was incorrect, he/she also made a subjective assessment of the reason for the error (e.g., the error was part of a fraudulent refund scheme, the error was made intentionally or was due to unintentional error/misunderstanding). When the agent considered his/her inquiries complete, they telephoned an experienced agent who acted as the national coordinator on the study. This senior agent reviewed the findings to ensure completeness of the inquiry and consistency with the other inquiries being conducted across the country. If satisfied, the senior agent approved the return of the file to the originating Service Center.

- C. After the file was returned to the originating Service Center, it was reviewed. If the return was deemed "part of a scheme," it was controlled as a fraudulent refund claim, and no refund was issued. If the claim needed adjustment (i.e., the claim was classified as having an intentional or unintentional error), the return was referred to the Examination Division for a correspondence audit with the taxpayer. If the claim were viewed as correct, the refund was released. Copies of these files were then forwarded to the Cincinnati Service Center for transcription into the sample database.
- D. All completed sample files were transcribed into a database for analysis. During this initial stage, tax examiners reviewed all case files to determine if they agreed with the Special Agent's assessment. The tax examiners' assessments of the cases were included in the data base. Subsequently, tax examiners reexamined the case files to determine the reasons for taxpayers' errors. Based on this more comprehensive review of the facts reported in the case file, the tax examiners changed their assessments in some cases. The database also contains this information.

Over the following months, data inconsistencies and errors were identified and corrected. The results from correspondence audits were added to the files as these contacts were completed. Also, additional comparative information was added to the database as it became available. For example, information reports (W-2s and 1099s filed with the Service) were matched to the sample files during the fall of 1994. Returns were also matched to the duplicate use SSN file to identify cases where other persons had also claimed the qualifying child.

Lastly, all cases were reviewed to assign "best and final" codes to the case file. When complete information was still not available from the Examination Division, the tax examiner made a "best and final" determination on the basis of the available evidence. These determinations were used for the purposes of the study only and did not affect the taxpayer's receipt of the refund.

IV. Calculation of Error Rates

A. Overclaims The following results represent the estimated number of taxpayers in the sample period population who claimed more than the correct credit. The error rates are reported as values and percentages of dollars. These statistics are weighted figures.

OVERCLAIMS TOTAL \$ CLAIMED AMOUNT OF OVERCLAIMS

VALUES \$1,480,000,000 \$386,000,000

PERCENTAGES 100% 26.1% <2>

<2> 38.8% of the 1,273,000 returns overclaimed BITC.

B. Underclaims The following results represent the estimated number of taxpayers in the sample period population that claimed less than the correct BITC. The error rates are reported as values and percentages of dollars. These statistics are weighted figures.

UNDERCLAIMS TOTAL \$ CLAIMED AMOUNT OF UNDERCLAIMS

VALUES \$1,480,000,000 \$13,000,000

PERCENTAGES 100% 0.9% <3>

<3> 6.1% of the 1,273,000 returns underclaimed BITC.

V. Estimate of "Net" Overclaim Rate

The estimates shown in Section IV, provide information on the amount of BITC claimed erroneously by taxpayers whose returns were accepted by the IRS. In some cases, the IRS would have detected erroneous claims by using conventional enforcement techniques (e.g. matching of returns to information reports). These estimates also do not reflect legislative and administrative changes which were implemented in 1995 in order to reduce errors. Since the study was conducted, the IRS has begun to reject electronic returns which either do not include a taxpayer identification number for BITC qualifying children or use a social security number for a child which has already been used by another taxpayer. In addition, the Schedule BIC no longer includes the supplemental credits for health insurance. These provisions were repealed in the Omnibus Budget Reconciliation Act of 1993, partly because of concerns by the IRS that it could not easily verify eligibility for the supplemental credits prior to the payment of a refund.

The overclaim rate can be adjusted to reflect the potential effects of conventional IRS enforcement activities and legislative changes which were in effect during the 1995 filing season. Adjustment for these actions would have reduced the estimated amount of overclaims by \$104.3 million (from \$386.3 million to \$282.0 million), reducing the dollar overclaim rate from 26.1% to 19.1%. As a consequence of certain IRS enforcement activities and legislative changes, the dollar amount of overclaims would have been reduced by about 27%. <4>

<4> In 1990, the IRS found that enforcement activities reduced the gross income tax gap between 23 and 26 percent for tax year 1987

Notably, this "net" estimate does not reflect the full extent of increased 1995 IRS enforcement activities. During the 1995 filing season, the IRS implemented new screening tests to detect questionable EITC claims. The screens were designed to identify returns with problem refunds which would not have been identified through more generalized detection methods, such as matching returns with information reports. In designing these new screening tests, the IRS has used the results of the 1994 EITC compliance study, as well as other information, in order to better identify problem refunds. During the 1995 filing season, such refunds may be subject to delays of up to eight weeks, while IRS further investigates. The net estimates do not reflect the effects of the new screening tests.

TABLE 1

Comparison of Weighted Sample Characteristics of 1993 EITC Claimants

Category	EITC Compliance	Study	1993 Statistics	of Income
	Number of Returns	Percent of Total		Percent of Total
Total Returns	1,273,000	100.0%	15,117,000	
Filing Status	_,_,_,		,,	
Filing Join	254,000	20.0%	4,979,000	32.9%
Household Other	1,003,000 16,000	78.8% 1.3%	9,622,000 517,000	63.78 3.48
Adjusted Gross				
Less than \$5,		8.4%	2,281,000	15.1%
\$5,000-\$10,00		25.1%		25.3%
		35.6₺		26.5%
\$15,000-\$20,0 Greater than	00 318,000	25.0%	3,500,000	23.2%
\$20,00	0 75,000	5.9%	1,507,000	10.0%
Source of Income Wages and	me			
Salaries Schedule C	1,270,000	99.8%	14,301,000	94.6%
Business In	come (*)	1.2%	1,980,000	13.1%
Interest Unemployment	36,000	2.8%	2,713,000	17.9%
Compensation	79,000	6.2%	2,110,000	14.0%
EITC Supplemen Health Insura				
Supplement Young Child	287,000	22.5%	2,953,000	19.5%
Supplement	147,000	11.5%	1,803,000	11.9%

 $^{(\}star)$ Estimate is not statistically reliable because of small sample size.

Chairman Shaw. Thank you, Ms. Richardson.

I would like to commend you and the IRS for many of the savings, and the compliance work that you have done in this area. It is a difficult area, and it is a rapidly growing expenditure of the Federal Government.

I was looking at Mr. Samuels' chart that was up there. Would someone please place that back up on the board? I think it is important to point out that the growth shown on that particular graph under the GDP is somewhat impressive, I would also like to point out that it is from 1997 to 2002, so this is something that has not happened.

I think we need to look at the historical perspective of what has happened. If my figures are correct, I show in 1985 that the program was \$2.16 billion, and it has grown, if we use the 1996 project, to \$25.86 billion. That is an increase of 1,100 percent. This makes it the fastest growing antipoverty program that we have.

It is interesting, because if you compare it with AFDC, it is far larger than AFDC, which is only about \$15 billion, Head Start is \$3.5 billion, food stamps is \$25 billion, so that we can see that the size of the program itself is just about the size of food stamps now. As a matter of fact, unemployment insurance is only \$27 billion, and housing is \$21 billion. This really adds up to be one of the huge entitlement programs that we have, and the phenomenal growth of the system I think requires a very close look.

In discussion with the members up here on the panel, it is not our intention at this time to try to gut this program. We consider this a very important part of welfare reform. I do not think that the majority side or the minority side has any intention of gutting the program, but there are some significant adjustments we should make.

In the Republican budget, it was viewed that we could save a little less than \$3 billion. In the President's budget, he viewed that we could save about \$3 billion. If there is one area that I think we are very close on, I think it is in this particular program that the Republicans and the Democrats agree on.

The Senate came up with a much larger figure, but they made a substantial alteration to the program that we on the House side have not spoken on.

Mrs. Johnson, do you have any questions? Chairman JOHNSON. Thank you, Mr. Shaw.

Mr. Samuels, there are just a couple of things that I wanted to go through with you. Do you have cost estimates on the three proposals that you have made and on the additional proposal?

Mr. SAMUELS. Madam Chair, the pending proposals that were in the President's budget raise approximately \$3 billion over 7 years. We do not yet have a revenue estimate for the proposal that we described this morning.

Chairman Johnson. Do you have any demographic information about the EITC rights of single workers? We only discussed this yesterday, but would you for the record get back to the Committee on those receiving the EITC who have no children, what are the age groups, what percentage goes to what age group.

Mr. SAMUELS. Madam Chair, our preliminary information—and we went back after we discussed this yesterday—is that workers

without qualifying children residing with them, share approximately the same age demographics as the rest of the EITC population, except workers without qualifying children have to be between 25 and 65. Obviously, there are no taxpayers under 25 who would receive it. As far as we can tell at this point, it is not that different from the rest of the EITC population, and we will be getting you more details on that.

Chairman JOHNSON. Thank you.

I would like to ask you one more question. I still have time to ask Commissioner Richardson a question. Later on, we are going to have some testimony to the effect that a credit reduces work incentives, based on some pretty solid work. Has the Treasury looked at this issue?

Mr. Samuels. Yes, we have and our view, as I mentioned in my remarks, is that we believe that, on balance, there will be a net increase in work as a result of the 1993 changes. We have looked at these studies, and a lot of them do not take into account those who were not in the work force moving into work, which is a very important purpose of the program. You have that positive incentive for those who are not in the work force to move into the work force, and for those who are at very low income levels to increase their work, and we think these effects overcome the work disincentive in the phase out period, on balance.

Chairman JOHNSON. Thank you.

Commissioner, I want to commend you on the steps that you have taken this tax filing season to address some of the problems of fraud and abuse in this program. At the beginning of the season when we held a hearing on this issue, the administration testified that they thought there was \$5 billion in fraud. It looks from the figures that you have given us today that that may have been an underestimate. I do commend you on your current program.

On the other hand, I want to ask you about an article that appeared in Tax Notes in the June 5 edition, and I quote, "Both the 1985 and 1988, TCMP, Tax Compliance Measurement Program, surveys indicated that nearly 40 percent of taxpayers who took the

EITC were not entitled to it.'

If you remember the figures that Mr. Shaw just read about how this program's costs have risen, 40 percent has got to be a real concern. "This did not lead to a legislative fix, and no real compliance program was put into place until the 1995 filing season. Analyzing Treasury's figures, the lack of quick action on the EITC problem could have cost \$10 billion."

No tax gap reports were ever issued based on the data of the 1985 and 1988 Tax Compliance Measurement Program reports. In fact, the last income tax gap report published by the IRS was from the 1982 tax compliance measurement report. How can Congress effectively meet its responsibilities to take legislative action to address areas of noncompliance, if the IRS does not bring compliance problems to the Congress' attention in a more timely manner?

Ms. RICHARDSON. I am not familiar with the article that you are citing from, but I believe that we have been trying to address this problem and I know we spent a good bit of time last year with this Committee, not just this current filing season, but last season talk-

ing about the EITC, what we could do, what we were planning to do.

One of the things that we did was try in a more scientific, if you will, or statistically valid way to analyze where the problems were and what needed to be done. In 1993, some of the problems related to the complexity, as Mr. Samuels testified. Congress did address two of the areas that had led to a lot of the complicating features, and I guess this is the first filing season that we are feeling the impact, positively, I might add, of having simplified the credit for a large number of people. We certainly have been trying to address the problems, both legislatively and with the help of this Committee and the Congress, as well as how through our stepped-up compliance resource efforts.

Mr. SAMUELS. Madam Chair, could I just add one thing?

Chairman JOHNSON. Yes.

Mr. SAMUELS. First, I want to thank you and the members of the Oversight Subcommittee for supporting the Treasury and the IRS and its enforcement efforts. As you know, the IRS began this filing season to match all SSNs and we needed your support to continue with that program, and we are very grateful for it. That is the only way we are going to get this compliance issue under control.

The other thing I would just mention is that when Treasury reported on refund fraud, the estimate was \$1 to \$5 billion for all refund fraud, not just EITC. We have refund fraud in other areas for which we are very concerned, as well. The estimate was \$1 to \$5

billion and it was for all refund fraud.

Chairman JOHNSON. I wanted to mention this at this time, because while we certainly have moved forward and the Commissioner has done an excellent job this filing season, they need to be far more aggressive. It is clearly there and the need to better use the information from our TCMPs is very great and we really cannot justify letting information lie for sometimes a decade before we act upon it. As we look at whether to allow another TCMP, which has some disadvantages for the taxpayers, we really have to look at how we get that information more readily, how it gets reported publicly, how we have access to it, as well as you have access to it. Some of those issues have not actually been very well worked out in the past.

Thank you, Mr. Chairman.

Chairman SHAW. Mr. Matsui will inquire.

Mr. MATSUI. Thank you.

I would like to thank both of the cochairs again for their approach on this issue, and certainly for the hearing and the manner in which it is being conducted.

I am going to be very brief. I have just three areas. In terms of the growth of the program, in 1985, of course, the program had started in 1975, and in 1985 that was before the 1986 Tax Reform Act. If I am not mistaken, in the 1986 Tax Reform Act that was sponsored by President Reagan and also Members of the House and Senate, we expanded significantly the EITC. In fact, we added about 6 million more taxpayers that were able to use the EITC. Is that correct, Mr. Samuels or Commissioner Richardson?

Ms. RICHARDSON. It was greatly expanded. I am not sure of the exact number.

Mr. SAMUELS. Mr. Matsui, we think it was probably around 4 million.

Mr. MATSUI. Four million. Since that time, the 1990 bill that increased it and the 1993 bill that increased it, obviously the purpose was to increase it to add more people to the credit, and, second, to increase or decrease the threshold so more of the working poor

would qualify.

Let me move to the second area, because there has been a lot of talk about individuals who have no minor children who receive this credit, which was an expansion of the program. We are talking about, believe it or not, for that person a maximum of \$314 a year. So, if that is a disincentive to work, I want to meet that individual.

But that is what we are talking about, is that not right?

Mr. SAMUELS. One point on that, Mr. Matsui, is that there was a suggestion that a single low-wage worker without qualifying children who was working full time for the entire year at the minimum wage was receiving excess EITC. In fact, that person would receive \$40 of EITC, and it would offset \$336 of income tax that that person owes. We think that when you look at it in that context, even at that level, that you do not have a problem.

Mr. MATSUI. In other words, at the minimum wage, we are talk-

ing about \$40?

Mr. SAMUEL. For somebody working the entire year, right.

Mr. MATSUI. Now, if the maximum credit is \$314, the study on the Tax Notes that was referred to, the TCMP—and maybe somebody can help me with this—there was a notion that there was up to 40 percent in errors. That was a 1988 study, if I am not mistaken, is that correct?

Mr. SAMUELS. That is correct.

Mr. MATSUI. Since 1988 when actually the expansion occurred in 1986, in 1990 and 1993, and certainly since September 1994 there have been some major changes, as you suggest, plus the 12 additional recommendations that you are making at this particular time, is that correct?

Mr. SAMUELS. That is correct, Mr. Matsui.

Mr. MATSUI. That data is based on old information that does not reflect all of the steps that have been taken?

Mr. SAMUELS. Right.

Mr. MATSUI. One would question the relevance of the TCMP study at this particular time.

Thank you. I have no further questions. Chairman SHAW. Mr. Zimmer will inquire. Mr. ZIMMER. Thank you, Mr. Chairman.

Commissioner Richardson, in 1994, the IRS eliminated the DDI, direct deposit indicator, claiming that the refund anticipation loans that have been offered to taxpayers eligible for the EITC are a source of fraud and that the elimination of the DDI, direct deposit

indicator, will reduce this fraud.

The Treasury Department's own Tax Refund Tax Force found, and I am quoting, "The issuance of the DDI should neither increase nor decrease the likelihood that the IRS will be the victim of ELF fraud." What specific evidence does the IRS have that indicates that the refund anticipation loans are a source of fraud, and how specifically does the DDI facilitate fraud?

Ms. RICHARDSON. I would like to ask Ted Brown, who is our refund fraud executive, a special agent with the IRS, to address that, because he has spent a significant amount of time on this issue, and particularly on the direct relation between the DDI and fraud.

Mr. SAMUELS. Also, Mr. Zimmer, if I can just mention before Mr. Brown responds, I believe that the quote that you read from the Refund Fraud Task Force assumed that all information and all matching could take place. It was a quote in the context of a situation that does not exist. That was my recollection of it.

Mr. Brown. Congressman Zimmer, the issue of refund anticipation loans was that they act as an attraction to fraudsters more than a direct link. They are on a track much like banks do not cause bank robberies, but people go there because that is where the

money is.

The refund anticipation allows fraud artists or fraudulent claimants to receive the proceeds of their claim within 24 to 48 hours. We can find no equivalent fraud claim situation where the payoff is that fast. It also removes the direct relationship with the IRS with the fraud claimant. It isolates, protects and insulates that claimant from coming through our system. If we identify a fraudulent claim subsequently, the perpetrator has already received the proceeds and in most cases has disappeared.

The primary concern we had with refund anticipation loans is that it increases pressure on the system, makes the system an easy target and the perpetrators get their money quickly and can disappear before our own detection systems could prevent that from

happening. That is the direct linkage that we found.

Ms. RICHARDSON. Also, Mr. Zimmer, it reduces any incentive for the lending agency to assess the creditworthiness of the borrower and we do not feel the government should be guaranteeing that a loan was going to be repaid. We think that is the job of the lender.

Mr. ZIMMER. Let me just repeat my question. I said what specific evidence does the IRS have that the refund anticipation loans are

a source of fraud? Do you have evidence of this?

Mr. Brown. We know that there are fraud schemes that we have identified that the use of the refund anticipation loan made attractive. You could create false documentation, create a false return, take it to an electronic return originator and submit that claim. They were not set up to detect fraud, they transmit the return to us and they make a loan for the proceeds, net their own fees and charges. The perpetrator within 24 to 48 hours gets the proceeds and disappears.

In many cases, even when we are successful in detecting the fraudulent return days later, that person is much more difficult to track down at that point and successfully prosecute because of that insulation. Yes, we have examples where that was the attraction, that is what made that fraud more attractive than filing a return

directly with the service.

The other concept in fraud control is called exposure period. If you can attempt to file a false claim and get paid in 24 hours or 48 hours, that is much more attractive than if you have to wait 6 or 8 weeks for a refund check to come to an address, and be present to receive your proceeds. That increases the risk. The obvious analogy is for bank robbery. The longer you stay in the lobby,

the greater your chances of apprehension, and that is exposure period in its most simple form.

Mr. ZIMMER. Is not the risk to the lender, rather than to the

fraudulent taxpayer or the IRS?

Mr. Brown. Only if we detect the fraud before we made the payment, which usually occurs on an electronic return in 8 to 10 days.

Mr. ZIMMER. This is an electronic return issue more than a re-

fund anticipation loan issue?

Mr. Brown. The banking industry made refund anticipation loans on electronic returns where we gave the direct deposit indicator acknowledgement saying that, yes, our preliminary screens indicate that there was no offset, no debtor offset and we were willing to pay the refund at that point.

Mr ZIMMER. Now, could you explain to me—and you and Commissioner Richardson have alluded to this—how specifically does the direct deposit indicator facilitate fraud? You said something about guarantee of payment. That is not what it is.

Mr. Brown. No, it is simply an electronic indication that, after we have received their return, it has passed the initial screens; that is, SSNs appear to be valid, there are no math errors on the return and, more importantly, that there are no debt offsets. Debt offsets mean either that this taxpayer does not owe a prior tax liability which is still open or that there is a debt that we are collecting for some other State or Federal agency, child care support being one of the large groups.

When we give that flag within 24 hours, it says at least at this point it looks like we will honor your request for a direct deposit repayment, and at that point the banks release the payment to the person who has made the claim. Then in our normal processing over the next 8 to 10 days, if we do not identify the fraud, we then make the payment to the bank. In most cases they receive their

payment before we are able to identify the problem.

Ms. RICHARDSON. It was virtually certain that a refund would be paid if a direct deposit indicator was given or there was no indication, that there was a debt offset, so the bank would make the loan and then receive the refund on behalf of the taxpayer, if you will, and a guarantee repayment of the loan.

Mr. ZIMMER. I do not understand why that is the fault of the

DDI.

My time is up. Thank you.

Chairman Shaw. Mr. McCrery is now recognized for 5 minutes. Mr. McCrery. Thank you, Mr. Chairman. I thank you and Mrs.

Johnson for holding this hearing.

I think it is clear that there is bipartisan support for this program. It happens to be my favorite assistance program, because it does reward people who work. I see it more as a means, though, to supplement wages and produce a living wage, so to speak, for low-income people in this country and a much more efficient way to do that than raising the minimum wage. I am very interested in continuing this program and seeing that it accomplishes its purpose.

The one danger to this program, though, is fraud and abuse. I want to compliment the IRS and Treasury for the efforts that you have made so far in trying to prevent fraud and abuse in this program. I think there is more work to be done, and occasionally this Committee may be called upon to provide you with more tools to use to accomplish that. We want certainly to work with you, I do,

at least, want to work with you to provide you those tools.

I have had the opportunity to meet with the Commissioner and go into these matters in great detail and I am satisfied that the IRS under Commissioner Richardson is trying to make this program work, and I encourage you to continue those efforts and to work with us on this Committee.

Ms. RICHARDSON. Thank you.

Mr. McCrery. I do have some concerns about the way the program is structured now. I do want these two Committees to look at benefits for single persons, as opposed to persons with families with children, and I think perhaps there are some changes that can be made to make the program more effective in those respects.

Mr. Samuels, did you happen to be listening to Representative

Petri's presentation?

Mr. SAMUELS. Yes, sir.

Mr. McCrery. If so, did you have any thoughts on that? It

seemed a rather interesting proposal to me.

Mr. SAMUELS. Mr. McCrery, my very preliminary reaction—and I think it was raised in a question—was that the proposal would shift EITC away from single parents with children to married couples with children, and it seemed to us that that was not a good policy. That was my very preliminary reaction and we will clearly look at this very carefully and give you our views on it. That is what we thought the result would be, just hearing it for the first time and looking at the schedule.

Mr. McCrery. That is an interesting comment. I wish you would look at that and give us your comments in more detail, because it does concern me that there is a significant marriage penalty in the EITC the way it is done now, and we may want to address that without unduly taking away from single parents, because certainly they have as hard or a harder time making ends meet than a married couple. It is of some concern and I thought Representative Petri had an imaginative proposal that deserves some attention.

Thank you for your efforts, and we look forward to continuing to

work with you to make this program work.

Chairman SHAW. Mr. Gibbons.

Mr. GIBBONS. I think we are caught in the Topsy syndrome here, by that I mean we have got a program that has grown like Topsy, and it has some problem with it and we need to straighten it out.

I am glad, though, to hear that it is still so widely respected by both Democrats and Republicans as far as being a viable, good type

of program, and we certainly need to correct it.

The GAO recently did an audit and filed a report on compliance, and I just ask this question in order to put this compliance order in perspective with overall taxpayer compliance. As I recall, and correct me if I am wrong, they said that 64 percent of all of the returns of self-employed were erroneous. Is my recollection correct? Is that the correct figure, 64 percent of all self-employed returns were erroneous in the GAO report? I think that is right, is it not?

Mr. SAMUELS. Mr. Gibbons, the GAO published a report last week entitled "Reducing the Tax Gap," and they indicated that self-

employed tax return filers did have a compliance problem and that the IRS estimates that income reporting compliance for self-em-

ployed taxpayers to be about 41 percent.

Mr. GIBBONS. I think that waves a red flag at this Committee. We had better pay some attention to that. I spent most of my life being a self-employed person and filing a self-employed return and I realized how difficult it was. I have a lot of self-employed friends, and I am sorry that the noncompliance rate is that high.

These are generally honest, hard-working people with a good education, and if they have that kind of compliance rate, it sure sends a warning to me that there is something wrong in the system out there, it is not the fault of Mrs. Richardson or Mr. Samuels, but I guess all the fault comes back here to the Congress and we

had better pay some attention to it.

As I recall—somebody is going to get sick of me recalling all these things—I was a conferee when we created this program back in 1975, and it happened about 4 o'clock in the morning here in this room. We were all exhausted and the Chairman of the Senate conferees, Mr. Long, brought up his earned income credit. He had put it in the Senate bill over there and we all sort of agreed that it was a pretty good idea, and we looked at the staff and said we hope you all can carry it out, and they said we can and that is how this thing got into law.

I did the first Oversight hearing on this, Mrs. Johnson, back when you were a young lady—a real young lady. Boy, I walked into

that one, didn't I? [Laughter.]

Anyway, it was not a big problem then. The program was only a few years old and we were just looking at it in the Oversight Subcommittee and it really was not that bad, but it seems like the compliance problems have gotten greater. I have just been looking over these worksheet forms that we have got here. I do not want to blame you for them, Ms. Richardson, or even Mr. Samuels, but I guess I have to blame the Congress.

You have got to be an accounting graduate to understand this worksheet form that we have here. You have to be a very patient and meticulous person to work that thing out. I think we probably need to go back and rethink some of the things we have done in this program. For instance, we really need to simplify what is income. I think we need to do that. Would you like to comment on

maybe simplifying what is income in all of this?

Mr. Samuels. Mr. Gibbons, I would be pleased to address that. Before I do, could I just mention that you referred at the beginning to the program growing like Topsy, and some people have said it is a program out of control. The program has grown as Congress said it was supposed to grow. The reason I say that is that when some people say it is out of control, they mean that it is growing in a way that nobody anticipated. We have the chart there to dispute these charges.

The EITC has grown in steps pursuant to the 1986, 1990, and the 1993 expansions. That is as Congress decided. It is not a program where costs were suddenly way beyond what anyone thought when Congress passed it. Once the EITC is fully phased in, in 1997, we expect growth to stabilize. We think the program is on

track in accordance with what Congress has required.

Mr. GIBBONS. I guess my criticism is more directed to Congress than it is to you because we are the ones that created this Topsy. It is really not as bad as some of the other programs we have created.

Mr. SAMUELS. With respect to simplifying the definition of income, the credit is now based on one's earned income and then is phased out based on the greater of earned income or adjusted gross income. If one was going to look at whether adjusted gross income was the right measurement one issue is that for example, self-employed taxpayers' adjusted gross income reflects deductions for health insurance and some of their SECA taxes. If you move away from adjusted gross income, there will be some distortions between the wage earner who is employed and the self-employed.

We would be pleased to consider whether there are ways of trying to simplify it, but that would be an issue that we think we

would have to look at very carefully.

Mr. GIBBONS. Well, the red light is on and I will not transgress on everybody's time but I have got a lot of questions about this program and I would suggest that all of us read the instructions that go along with this form and see if there is not some way we can improve it, not just you but all Members of this Committee.

Thank you.

Chairman SHAW. Thank you, Mr. Gibbons.

The Chair will now recognize Mr. Camp for 5 minutes.

Mr. CAMP. Thank you, Mr. Chairman.

Commissioner Richardson, I have a question I would like to ask you. I commend your efforts in the area of fraud and wish that you would continue to pursue it so that the viability and broad support this program has is not eroded.

Right now, recipients can get advanced EITC, up to 60 percent of the benefit. And the Governor of Michigan has a proposal that would let people receive advanced EITC through State agencies so that people on welfare would file at the State level the same form they now file at the Federal level to get this advanced EITC.

The amount would be obviously calculated based on their earnings as it is now. It would allow them to get this monthly payment in a separate check. The benefits of this proposal, I think, would give an increased incentive to people who are working and on welfare to receive this money as they are working rather than in a lump sum at the end of the year and help with the whole concept of work paying. I think this might increase the number of people who are on welfare to take advantage of the EITC.

I would like to receive your comment on this. Mr. Samuels, if you

have any comment, I would be happy to hear that also.

Ms. RICHARDSON. Mr. Camp, I am a very strong supporter of the advanced EITC. I think it makes good sense in a lot of ways. We have labored mightily, if you will, to try to promote it and expand it over the last couple of years. One of the disappointments—and we have been successful—but one of the disappointments I have is that we have expanded from 52,000 or almost 53,000 taxpayers claiming it last year to only 189,000 this year, in the same time period.

It is a significant percentage increase but it is not a lot of the claimants. From the standpoint of our efforts to reduce fraud we

think it is an important feature. When I was out in Minnesota a few weeks ago talking with my counterpart in the State of Minnesota, I learned they are very anxious to do something similar to what the State of Michigan would like to do.

I know we are very supportive, as is the Treasury. Mr. Samuels can address it, helping both Michigan and Minnesota work on these plans. We think it can help our compliance and help the peo-

ple who have really earned the EITC.

We are supportive of the advanced notion and we will do anything we can to help the States make it work in concert with their benefit packages.

Mr. CAMP. I appreciate that.

Mr. Samuels. Mr. Camp, last year the administration proposed that there be a pilot program involving four States, and Michigan could be one of those pilots if the proposal was enacted. We support these pilot programs. We think they are very important. It will give us information about how the program is working, and how we can make it work better. In my written testimony, we state that we support the legislative amendments that are needed to permit these pilot projects to take place. In trying to make my remarks as brief as possible, I failed to mention our support for these pilots, but I want to state, for the record, that we strongly support those pilot programs. We think we should try to do that as quickly as possible so that we can see how the States can assist hard-working, low-income taxpayers in receiving the EITC on a monthly or periodic basis throughout the year. We think that is a very good proposal.

Mr. CAMP. Is the advanced EITC available to all those who qual-

ify or only those who have children?

Ms. RICHARDSON. Only those who have children.

Mr. CAMP. All right, thank you very much. Thank you, Mr. Chairman.

Chairman SHAW. Thank you, Mr. Camp. The Chair will now recognize Mr. Rangel. Mr. RANGEL. Thank you, Mr. Chairman.

Earlier this year I was extremely critical of this so-called Contract With America because, in my opinion, it was penalizing people who were poor and dependent on government. I said they had to go to work and, yet, it did not seem to say where those jobs were to come from.

This time, I would like to compliment the Chairs of both the Oversight Subcommittee as well as the Human Resource Subcommittee because they emphasize what most of us have been say-

ing, that most people want to work.

I think that this program removes the temptation of trying to evaluate how much you get from welfare and how much you get from working. This is a unique type of program that encourages people to get into the work force and stay. It gives them an opportunity to look for better jobs once they get on their feet.

I do not see where it is exploding because it levels off in 1997. It does what we want. I do not even know how we could measure the cost, Chairpersons, because in a large number of cases it has completely eliminated the need for AFDC and other supportive

programs.

I want to thank both of you and your Subcommittees for working with the administration toward the common goal to eliminate the errors and frauds that have been committed in the past and even more so to continue to work because still a lot of errors exist in this program.

I might even suggest, if the rules permit, that maybe we could have a work force, Republicans and Democrats just to get in a room with the administration and talk this thing out to see how we can perfect it without a lot of hearings and when we come to hearings

just do what has to be done.

I do hope that in this newly created atmosphere of bipartisanship, which the President and the Speaker has started and I do not fully understand, that we could, keep people who want to work, working. I think, overall, it is good for our Nation and certainly good for our economy.

I want to thank the administration for admitting that there have been a lot of errors and requesting legislation in order to keep them down and corrected. Whatever contribution I can make I

want to be a part of it.

Thank you.

Chairman SHAW. Thank you, Mr. Rangel, for that most historic statement. [Laughter.]

The Chair now recognizes Mr. Collins. Mr. COLLINS. Thank you, Mr. Chairman.

Mr. Samuels, in your testimony you mentioned the fact that the President is addressing some of the problems with the EITC in his budget. Which one of those budgets? Was that the one early on that failed by 100 percent in the Senate or the one introduced this week?

Mr. SAMUELS. Mr. Collins, it was in the original budget submission and it was in the one that was made public this week.

Mr. COLLINS. It was in the one that was made public?

Mr. SAMUELS. Both of them.

Mr. COLLINS. It was in both, well, that is good. Consistency is unusual, that is great. It has been said that the EITC is a reward for work. But I have a lot of problems with that. I think reward for work should be based on productivity and the pay should come

from the employer.

However, I see the EITC as being not so much coming from the employer as it is coming from fellow employees. I base that on the fact that if you have two people working side by side on an assembly line or some job, and they are earning equal amounts of money, say, \$8 an hour, and the one worker has a wife and one child and the other worker has a wife and two children. There is quite a difference in the two as far as the net tax liability.

In fact, the couple with the one child or the worker with the one child will actually pay \$368 more in tax liability and receive \$319 less in EITC for a total difference there of about \$687 liability to

the government.

Therefore, it appears that you are taking from the one worker with one child and supplanting the worker with two children with part of the income.

I have a problem with that. I think the reward for work, again, should come from productivity and then in pay from the employer.

With the EITC it appears that a lot of it comes from fellow employees.

Two, the purpose of the EITC was to rebate or to offset the Social Security or the FICA taxes. However, when that same worker reaches the age of 62 or 65, depending on the age, they are still eligible for the Social Security. Again, they will be subsidized by other employees.

I think we have some real problems in this system and I hope the administration does come forth with some proposals that will

help clarify this problem.

I thank you for being here, and you, too, Ms. Richardson, thank you.

Ms. RICHARDSON. Thank you.

Chairman Shaw. Thank you, Mr. Collins.

Ms. Dunn.

Ms. DUNN. Thank you, Mr. Chairman.

I wanted to make one point that I would like Ms. Richardson and Mr. Samuels to be aware. When we wrote the portion on child support in the welfare bill that passed the House of Representatives we believed that one major thing that could become a Federal responsibility was our assistance to States who were seeking deadbeat parents and seeking the funds that they owed to these children, believing those funds, which as I recall totaled \$34 billion owed to children, would be a good way to get these kids off the welfare cycle.

In doing that we decided to establish a national registry and that would be an access resource that could be accessed by the units

that exist in all the States.

I wanted to bring this to your attention because my question is, as long as we have employers who are submitting W-4s to the national registry and States have access, do you see this, Ms. Richardson for example, as a potential source of information as you are checking on EITC incomes, since that tells exactly and specifically

what these folks are making in their jobs?

Ms. RICHARDSON. I am not intimately familiar with the details of your proposal, but, yes, I think that could be very helpful. One of the things that I think we have to be very aware of as we are asking the IRS to do these kinds of things is that we are dealing with very antiquated technology right now. Our ability to verify information and do it in a timely fashion is very much dependent on our being able to continue to receive the funding and support for our tax systems modernization.

We will not have the capacity to do some of the things that people would like us to do in the compliance area and in the area you have mentioned without having a modern information system.

Mr. Samuels. Ms. Dunn, I think that it would be an issue that we would like to look at. At the end of my testimony, we mention areas we want to explore, and one of them is sharing data with the States. This registry would be the type of thing that we would want to carefully look at. I appreciate your bringing it to our attention, and we will look at it very carefully.

Ms. DUNN. Thank you and I am glad that you have that attitude because I, too, want to get rid of overlap but, on the other hand, we want to provide any resource that would be helpful and useful

in finding information. This, as I understand, has also survived in the Senate welfare bill which has not been voted on but in conference, I suspect that we will be able to have that source as a resource.

Thanks.

Mr. PORTMAN [presiding]. I have one final question as the interim chairman here, as everyone else has gone to vote. I told Chairman Shaw that I could run very fast over to the vote if he

would let me ask a question.

First of all, I want to thank both of you for being here and for the very interesting testimony. Mr. Brown, I think we had the opportunity to meet in Cincinnati a few months ago and I learned quite a bit about the efforts that you have undertaken in northern Kentucky and back here in Washington in terms of fraud. I tend to believe, in the context of Mr. Zimmer's questions, that we are making a lot of progress in that area. I think you are doing the right things and we still want to see some results.

Commissioner Richardson, I think you all ought to be com-

mended for handling the fraud problems that have arisen.

Ms. RICHARDSON. Thank you.

Mr. PORTMAN. My question really goes to the income issue. We talked earlier about dividend and interest income and I am very much in agreement with the administration proposal on that. I think others have raised that issue before, the notion that unearned income ought to be part of the calculation.

How about other forms of income? I can give you a quick list here. I think you are probably familiar with this issue, but Social Security income, Railroad Retirement benefits, pension annuity income, veterans benefits, workers' compensation, unemployment compensation, alimony payments? Should not those items also be included in that they represent replacements for earned income?

Mr. SAMUELS. Mr. Portman, I believe that some of those items, like alimony, are included in adjusted gross income. So, in effect,

it is counted.

I think there are two separate issues. One issue is that we have a new provision that is a modified form of the administration's proposal. If a taxpayer has more than \$2,350 of interest, dividends, and net rents and royalties, then that person is not entitled to the EITC.

There has been some suggestions that maybe one might want to expand the items of income includable under the investment income cap. For example, in a bill that has been introduced in the Senate, distributions from trusts and estates would be added to that amount. When thinking about ways to make the credit better targeted, I would urge the Committee to think about whether you are going to increase complexity which increases error rates and whether the IRS verify these new rules.

For example, on trusts and estates, we have calculated that there are about 10,000 to 20,009 EITC recipients who have income from

trusts and estates.

If you wanted to deny the EITC to those taxpayers, you will be, in effect, increasing the burden of all 21 million people who are claiming the EITC in figuring out how to calculate the credit.

Mr. PORTMAN. I can appreciate that and if it is a very small number then that goes to Mr. Gibbons' point. I would just think on Social Security though, we would have a number of recipients and

that might be one we could include.

Mr. SAMUELS. Right. I think Social Security is another one where I think when you look at the details, you will have concerns. Under the proposal, EITC recipients who would now be receiving non-taxable Social Security benefits, would be required to add them back into income. This would affect some recipients who are receiving EITC because they have qualifying grandchildren living with them.

The question is whether you want to treat that Social Security recipient somewhat differently by taxing their benefits because one or both of the grandparents is working and caring for their grandchild, but not taxing the benefits of the neighbor next door who is

not caring for a grandchild.

The other situation may be a married couple, where one spouse is working and the other is receiving disability from Social Security because an accident or some kind of illness. With Social Security, you have to just decide whether these are the types of situations where you would like to cut back on the EITC. I think it is something we would be pleased to discuss with the Committee, but those are the considerations.

Mr. PORTMAN. Madam Commissioner, if you would be so kind as to put any answer in writing because I have to make the sprint across the avenue?

Ms. RICHARDSON. OK.

Mr. PORTMAN. If you will be willing to stay for additional questions, I think on the other side of the aisle we have some questions.

Ms. RICHARDSON. I just have two simple pleas on that point, something that is easily verifiable and something that is simple. That really makes our job much easier. Thank you, very much.

Mr. PORTMAN. Thank you all and we will recess for 4 or 5 minutes.

Thank you.

[Recess.]

Chairman JOHNSON [presiding]. We will resume the hearing. In view of the other panelists that we have ahead of us, we can begin the hearing. Before I recognize my colleague from Michigan, I

would like to ask the panelists each for some information.

Mr. Samuels, would you please get back to us—I want to make this as a formal request on behalf of the Committee—with an analysis of Mr. Petri's proposal? As I listened to his testimony I shared your concern but I believe that later on in his testimony, he did answer that issue of the possible shift away from support for singles.

Knowing him, as I do, and knowing the depth of work he has done on this issue over about the last 12 or 15 years, I think it is important that this Committee take seriously his testimony. He is the only Member who has ever gone into this in great detail and he knows a lot about it and he is extremely smart and I think we all need to look at his proposal. If there is some way we can alleviate the marriage penalty we certainly have an obligation to do so.

I would look forward to hearing from you on that.

Mr. SAMUELS. We will be pleased to do that.

Chairman JOHNSON. And Commissioner Richardson, this goes to Mr. Gibbons' comments earlier and his frustration with the amount we do and do not know about the effectiveness of our Tax Code.

The last time this Committee received any tax cap reports was in 1982. I would like to formally ask you and the IRS to provide us with tax gap reports from the 1988 TCMP and those would include the employment tax gap reports, the individual income tax gap report, and the corporate income tax gap report.

[The aforementioned report is being held in the Committee files.]

Thank you.

I will now recognize Mr. Levin.

Mr. LEVIN. Thank you, very much, Mrs. Johnson.

Like my other colleagues, I very much welcome the spirit within which this hearing is being held. Let me just mention to you—our numbers have dwindled here—but I think the issue remains very important.

My concern is what is going to happen in the budget conference? Because there is a major gap between where the House is and

where the Senate is on the EITC.

Chairman JOHNSON. Well, I think the budget conference will come up with its proposal, but each Committee will have its target

and how we achieve those targets is going to be up to us.

Line item in the budget resolution does not actually govern appropriations decisions nor do they actually govern tax decisions. Our job is to assure a workable fraud-free EITC and make any other reforms we think are appropriate. I do not consider our work governed, at this point, by the budget conference.

Mr. LEVIN. I am glad to hear you say that though, at some point, the budget resolution can carry instructions that would be so stringent a budget target for this Committee that it might tend to move

us in a direction that is different from the spirit here.

Look, I think the fraud and abuse problems have to be grappled

with and to the credit of this administration it is doing that.

Let me just ask, so that we all are clear on this, the Senate number would have what implications, Mr. Samuels, beyond fraud and abuse? I take it that there you cannot get \$20 billion from doing

what we need to do on fraud and abuse, is that right?

Mr. SAMUELS. That is correct, Mr. Levin. The Senate budget resolution assumes enactment of the administration's compliance proposal. That is the proposal to deny the EITC to undocumented workers and to allow the IRS to use the simplified procedures for dealing with taxpayers who do not provide correct Social Security numbers.

That proposal is their only compliance initiative. The balance is a cutback in the program. As the board up there shows, an EITC taxpayer with two or more children, on average, would have a tax increase of \$305 in 1996, and that number does not include the compliance amount. That is everything other than the compliance amount. Obviously for low-income workers who are receiving the EITC that is a significant amount.

Mr. LEVIN. Right. I just raised this because I really think that this discussion here, and it has been a useful one, will hopefully

have some impact on the conference committee. Otherwise, those who have spoken here in support of EITC could be put into a position where it would be very difficult to carry out, the gist of this

hearing.

Chairman JOHNSON. I think as the Congress looks at every appropriated program, we will also look at every tax expenditure program and look at what is in the public's interest as we seek to establish a spending pattern that will lead to balance by the year 2002. I cannot guarantee to anyone here, that as we look at the relative value of every program that we will not look at the relative value of the EITC Program. But, I consider that a different issue than making the law state of the art and the best law that we can make it.

I also think it is very clear from this hearing and from the history of this program that there is very deep bipartisan support for

this particular program.

Mr. LEVIN. We are all together on effectively weeding out the fraud and the abuse. If I had time I wanted to ask our two distinguished witnesses to comment on the incentive. Later there will be testimony on whether or not the EITC is an incentive or a disincentive.

Do you want to comment briefly on that?

Mr. SAMUELS. Yes, Mr. Levin, we believe that the EITC is, on balance, a net incentive.

Mr. LEVIN. But the argument in some of the testimony is that especially in the higher income, in the ranges as you move up of

those covered by the EITC it becomes a disincentive.

Mr. SAMUELS. Families in the phaseout range tend to be people who are much more attached to the work force. We would not expect them to respond by cutting back on their work, except, in the situation where both spouses are working, and one might decide to reduce their work hours to stay home and take care of the children because of the EITC. We do not think that is a bad outcome.

Obviously, there is a work disincentive any time you have a phaseout but we think the group that is subject to the EITC phaseout is more attached to the work force. For those who might reduce their work hours, the choice may be to stay at home and take care of children.

Mr. LEVIN. Thank you, Madam Chairman.

Chairman JOHNSON. Mr. Herger?

Mr. HERGER. Thank you very much, Madam Chair. I want to commend both of you at the Treasury and the IRS for taking some much needed steps to eliminate the fraud and abuse in the EITC program. Even with the changes, the EITC still adds a layer of complexity to our current system.

Mr. Samuels, I might ask of you, in your opinion, is there any way that we could perhaps juggle the income tax or FICA tax rate brackets like perhaps setting a floor on FICA tax, while providing the same relief to the same families, and at the same time reduce this complexity of the Tax Code with the EITC the way it is currently set up?

Mr. Samuels. Mr. Herger, we have looked at those suggestions. Let me just say as you know we are really committed to thinking of all possible ways to make the program as efficient as possible.

My reaction so far to what I have heard of these proposals is that the promise of simplicity and reduction in error rate is a mirage. We would be here talking about exactly the same issues; how to

target the FICA floor to the right population?

If you are trying to administer this through a payroll tax system, how are employers going to decide which employee is supposed to be able to get the benefit? You have employees who have multiple jobs. You have couples. Employers will have to figure out who is supposed to get the appropriate benefit, because you are not going to give the FICA floor to everybody. You have to target it.

I think that you would find, at the end of the day, that we really would not have made any progress in either simplification or targeting. And, in addition, it means that you would require employees to go to their employers and explain to them that they are entitled to this benefit, and many employees do not want to have

that conversation.

As Commissioner Richardson mentioned, we have been working hard on outreach programs to encourage the advanced payment. While we have seen some success, overall as a percentage of the total, it is still a small fraction of the total number of EITC recipients. We keep asking ourselves why we cannot we do better in getting recipients to claim the advanced payment, because we think that would be a good way of delivering the EITC.

One conclusion is that employees do not like to go to their employers and explain to them that they are entitled to this program. Given the relationship between the employer and employee, I think that there is some question about whether employees would choose to describe what their circumstances are to their employers. In addition, I think sometimes there is a question of whether the employer might say, "Well, now, I know you are getting this benefit, so, I am not going to give you that raise." Finally, we have had very serious problems with the targeted jobs tax credit which is also a credit for employers. These are different programs, I am just giving you a very broad view. Our experience with the targeted jobs tax credit was very unhappy, and we have said we would not support its extension unless it has some serious changes made to it.

When we have looked through these proposals, we think that you wind up with a different set of problems in some sense, but these problems are going to be as serious or more serious than what we currently have. We now have a program that a lot of people understand, and where we feel we are making progress on the error rate issue with the steps that the IRS has taken. That is very important to the proposals we have made and Congress has passed. We have proposals here, before you, which we think will make a significant difference.

We think we are on track and we need your support to continue that and we appreciate your support so far this year on trying to get a handle on this issue.

Mr. HERGER. Thank you, Mr. Samuels.

Chairman SHAW. Mrs. Kennelly.

Mrs. KENNELLY. Thank you, Mr. Chairman.

Mr. Chairman, I would like unanimous consent to place an opening statement in the record.

Chairman Shaw. Without objection. Any Member who has an opening statement, it will be made a part of the record. [The opening statement and attachments follow:]

OPENING STATEMENT OF BARBARA B. KENNELLY

EITC Hearing

"The best anti-poverty, the best pro-family, the best job creation measure to come out of the Congress." These are the words of President Ronald Reagan.

As an advocate for the EITC, I agreed with President Reagan, and worked with him on the 1986 indexing expansion changes. I worked with President Bush on the largest-ever expansion in 1990. I worked with President Clinton on the 1993 simplification and expansion. Historically this is a program that has enjoyed strong bipartisan support.

I am pleased that we are having this hearing today to examine problems with the EITC. Let there be no mistake—where errors are made, they must be corrected and where even one dollar of fraud exists, it must be found, stopped and those responsible prosecuted.

I would hope that on a bipartisan basis we can focus on finding solutions to the real problems in the EITC. I would hope that we can distinguish an honest taxpayer mistake from criminal fraud, correct the former and punish the latter without taking benefits away from innocent hardworking EITC families. And perhaps, I would hope that we can acknowledge the multitude of things the Internal Revenue Service has done to stop fraud and find errors as well as recall the many changes the Congress has made in this program in the past 2 years that should address error and fraud. In this area, I would like to include for the record 12 steps the Administration has taken to reduce error rates.

And once we have a real picture of what the problem is and the changes that are in place to address the problem, I would hope on a bipartisan basis, we can take the additional steps necessary to eliminate fraud and minimize errors in the program.

In 1993 some 84,856 families in Connecticut received the EITC. We

have tremendous income disparity in Connecticut. For instance, in 1995 45% of all Connecticut families with one child that file as head of household will generally qualify for the EITC while a mere 9.9% of Connecticut families with one child that file married filing jointly will qualify.

Similarly, in 1995 48% of all Connecticut families with two or more children that file as head of household will generally qualify for the EITC while just 10.8% of Connecticut families with two or more children that file married filing jointly will qualify.

The EITC is particularly critical for these families headed by one parent--often a divorced parent with children or a young mother struggling to get off welfare. It is on their behalf that I am very concerned about proposals in the Senate-passed Budget Resolution that would increase their taxes. CT families with one child would have their taxes increased by \$1,436 over 7 years by the Senate Budget Resolution. CT families with two or more children would have their taxes increased by \$1,778 over 7 years by the Senate Budget Resolution.

What I find particularly troubling is that 90% of the reduction in the EITC in the Senate Budget Resolution has nothing to do with reducing errors, eliminating fraud or ensuring that those not entitled to the credit do not receive it. This Member is willing to do whatever is necessary to reduce errors, eliminate fraud and ensure that those not entitled to the EITC do not receive it. But this Member has NO interest in increasing taxes on struggling families in Connecticut.

I am also greatly troubled by the suggestion that we count child support payments as income for EITC purposes. This simply makes no sense and would represent a major step backward in child support enforcement. Such a change would add unbelievable complication to the EITC--complication that only leads to additional errors. The one thing this program doesn't need is more errors!

Further, the IRS has no data on child support payments, therefore, it would be impossible for the Service to verify this information. I am particularly troubled that non-custodial parents are already taxed on child support payments. To count child support payments as income for EITC purposes would amount to double taxation. I do NOT support taxing child

support payments!

Such a change could also actually lessen child support payments whereby divorced payments who find themselves in danger of losing the EITC could negotiate to maximize the EITC and minimize child support payments.

Inclusion of Social Security in income for EITC purposes raises equally troubling questions and should be rejected.

Finally, the House-passed version of welfare reform would eliminate the restriction on how States treat the EITC for AFDC recipients. Under the House-passed bill, States could elect to count all or part of the EITC as income available to an AFDC family and reduce AFDC benefits accordingly. Lump-sum EITC refunds, which 99% of EITC families receive, could be treated by States as an asset immediately available to an AFDC family, thereby disqualifying them from AFDC. Surely EITC is supposed to be an incentive to work, a helping hand in making the transition from welfare to work. I would hope that within the context of EITC reform we can revisit this issue.

Thank you.

TO IMPROVE THE EITC AND REDUCE ERROR RATES 12 ADMINISTRATION MEASURES

Source : Truemany, May 13, 1995

Simplicity and Veriffability

- The Clinton Administration recognizes that error rates are a problem and has acted aggressively to reduce them.
- Specifically, the Clinton Administration is committed to structuring the EITC so that deserving and eligible individuals--and only those individuals--are able to claim and receive the EITC.
- If eligibility rules are simple, taxpayers can more accurately claim the EITC and Two key means to this end are the simplicity and verifiability of EITC claims. avoid costly errors.
- If eligibility rules are verifiable, the IRS can better ensure that the EITC is paid only to those who are eligible.
- The Administration has taken 12 measures to ensure the simplicity and verifiability of the EITC and to reduce erroneous or undeserved claims.

OBRA 1993

- The EITC was simplified by repealing the complex supplemental credit for health insurance
- Some taxpayers made mistakes in their claims because they did not understand the complicated eligibility criteria.
- The EITC was further simplified by repealing the supplemental credit for children under the age of one. ri
- eligibility criteria for the young child credit, and the rules were difficult to administer. This should also improve EITC compliance, as taxpayers could not understand the •

Uruguay Round Agreement Act of 1994

- 3. The EITC was denied to nonresident aliens.
- Under prior law, nonresident aliens could receive the EITC based on their earnings in the United States, even though they are not required to report their worldwide income :
- Prisoners will not be eligible for the EITC based on their earnings while incarcerated. 4.
- The EITC was never paid to prisoners, and this ensures that it will not be paid to them, now or in the future.
- Taxpayers will be required to provide a taxpayer identification number for each EITC qualifying child, regardless of age.
- This will allow the IRS to verify eligibility for each child claimed by the taxpayer.
- The Department of Defense is required to report to both the IRS and military personnel non-taxable earned income paid during the year that is included in computing the EITC. છં
- This will ensure that military personnel receive the benefit for which they are eligible.

Verifying and Delaying Questionable Refunds

The IRS has instituted a series of tough new administrative measures to reduce error and fraud in the EITC. The IRS now scrutinizes the social security numbers of all EITC qualifying children.

∞:

- Children's social security numbers are checked to make sure the numbers are valid, and no child is claimed more than once.
- EITC returns filed electronically. This year, the IRS is tightening its validation tests Last year, the IRS only validated the social security numbers of children claimed on and checking all returns--whether they are filed electronically or on paper.
- Refunds on returns with missing, invalid, or duplicate social security numbers will be delayed, while the IRS investigates further. :
- EITC refunds may also be delayed if the IRS has questions regarding the validity of the 6
- Certain taxpayers will be required to provide additional documentation to verify that their EITC claim is valid before the credit is awarded.

As of April 21, 1995, the IRS has delayed refund checks to 6.5 million filers as a consequence of these two actions.

Intensifying Scrutiny of Electronic Return Originators

- quick signal from the IRS that a taxpayer was going to receive a refund check. Preparers fraudulent, the IRS -- not the preparer -- was left with the bill if the taxpayer disappeared used this information to advanced taxpayers loans on their refund checks within a couple indicators (DDIs) to preparers of electronic returns (EROs). The DDIs gave preparers a days of filing a return. With the DDI, the taxpayer would receive a loan, and the IRS would pay the refund directly to the ERO. If the return was later determined to be Beginning with the 1995 filing season, the IRS is no longer providing direct deposit with the refund anticipation loan. ⊙.
- Eliminating the DDI provides EROs with greater incentives to check the eligibility of EITC claimants. Preparers will not find it in their interest to advance refund anticipation loans to filers who may not be receiving a refund from the IRS.
- responsible for refund fraud. The IRS has taken several steps to stop this practice: In its enforcement activities, the IRS has also found that some EROs have been
- Fingerprint and credit checks are conducted on certain new ERO applicants.
- IRS is conducting additional compliance checks to ensure that EROs are meeting new, stricter requirements for participation in the program.
- The IRS is working with the Justice Department to prosecute preparers and EROs who take advantage of the EITC to defraud the Federal government.

Preventive Actions

- The 1994 Schedule EIC was shortened and simplified to make it easier for low-income taxpayers to understand if they are eligible for the credit.
- required to provide valid social security numbers for all dependents and EITC qualifying Taxpayers were also warned on the cover of the 1994 tax return that they would be 12.
- invalid social security numbers received letters from the IRS alerting them to be more In December 1994, over 180,000 taxpayers who filed in 1994 with incorrect or careful on their 1995 tax returns. :
- IRS participated in extensive media campaigns before and during the filing season to emphasize the need for accurate SSNs. •

Additional Proposals To Reduce Errors Still Pending

- The Administration submitted additional proposals as part of the President's FY 1996 budget which are still pending final legislative action.
- The EITC would be denied to undocumented workers.
- 60 days to provide a correct social security or, if they failed to do so, could refile with the The IRS would be authorized to use simpler and more efficient procedures when taxpayers fail to supply a valid social security number. Taxpayers entitled to the credit would have correct information to obtain the EITC.
- In combination, these provisions would strengthen the IRS's ability to detect and prevent targeting of the EITC by providing the credit only to individuals who were authorized to erroneous refunds from being paid out. In addition, the proposals would improve the work in the United States.
- IRS's collection functions. TSM will also enhance the IRS's ability to detect erroneous systems modernization (TSM) program. TSM is vitel to the long-run efficiency of the The FY 1996 budget for the IRS contains funding for the continuation of its taxpayer
- Last year, the Administration also proposed State demonstration projects to provide alternative ways of delivering advanced payments of the EITC.

We hope that Congress will act on these proposals soon.

Mrs. Kennelly. Mr. Samuels and Ms. Richardson, thank you for coming this morning, but also thank you for your work in making the EITC work. It is a good program and I know if it had not been for your efforts in the last year or so we would not be where we

are today.

Before I ask a question, I would just like to make two points. One, I think we have to be awfully careful not to interchange the word, error and fraud and then come up with a percentage of abuse. Fraud is against the law and it should be prosecuted, but a lot of people make errors, as you know, on the IRS forms. I thank the Chairman for his remarks this morning and for support of the program.

I think we have to remember that in the Senate, that 90 percent of the dollars that they are looking to take from the EITC are not in fraud or error related, it is literally to withdraw money from the

program, I thank the Chairman for appreciating that.

Mr. Samuels, back to the Senate, they have suggested that we include child support enforcement and Social Security when figuring out the EITC and I wonder how you feel about that?

Mr. SAMUELS. Well, on the child support, we have a concern about that proposal. We should be encouraging a taxpayer who is responsible for taking care of children to get the child support that he or she, generally she, is entitled to.

If you add child support to income, you are going against that policy. For that reason, there has been a very long tradition of ex-

cluding child support from taxable income.

The second problem with child support is that the IRS does not have any way to verify whether somebody is getting child support. By adding child support to income, you then set up a situation where we are inevitably going to have errors because one, people have never been required to include it in income; and two, we have no way of checking.

I think it would be setting up a situation which would increase the complexity of the calculation for millions of working Americans and, at the same time, cause a potential for errors. We have signifi-

cant reservations about that proposal.

With respect to including Social Security payments, I think when you were out voting we discussed that proposal. I said the considerations to take into effect are that you have kind of two situations. First, a person who is receiving Social Security working and taking care of maybe a grandchild would all of a sudden be treated differently than their neighbor who is getting Social Security and is not taxed on their Social Security because they do not work or care for their grandchild.

Then you would have a situation where one spouse is working and the other spouse is on disability. I do not think anyone anticipated that the disability insurance program might result in a loss

of tax credits.

Those are some of the considerations on Social Security that we think you ought to evaluate. Again, we do not receive reports on Social Security from the Social Security Administration (e.g., 1099s) so that we can check, so it would also raise a compliance issue.

Mrs. KENNELLY. Ms. Richardson.

Ms. RICHARDSON. Congressman Kennelly, my two principles would be that whatever changes are made we need to keep them simple and easily verifiable. Those are the two things that are the most important to us as an administrator in making the program work. We hope any changes that are considered can be easily verified and will not do anything to add to the complexity for the taxpayers.

Mrs. KENNELLY. Thank you. Quickly, Mr. Samuels, can you just comment on one of the suggestions in the Joint Tax Committee Report that the EITC be replaced by an employee FICA credit. Have

you heard of that one?

Mr. SAMUELS. Yes. Mr. Herger asked me about that and I said that I thought it would be a mirage. When you actually look at these proposals, we will be back here talking about the same problems—targeting, compliance, how do you know whether the person is entitled to it—so we do not think these proposals are an improvement.

Mrs. KENNELLY. You think that is a nonstarter?

Mr. SAMUELS. Yes.

Mrs. KENNELLY. Thank you, sir.

Thank you, Mr. Chairman.

Chairman SHAW. I would like to follow up for just a moment on some of the questioning that you had with regard to income that is excluded. You spoke of child care being excluded in the computation. Is alimony—

Mr. SAMUELS. Alimony is included in income. It is deductible by the—

Chairman SHAW. It is; so, is there any taxable income that is not included in the computation of the EITC?

Mr. SAMUELS. Taxable scholarships and fellowships are not included for earned income purposes but they are included for the adjusted gross income purposes. I think basically all the items—

Chairman SHAW. You work off of the adjusted gross income?

Mr. SAMUELS. Yes, sir.

By the way if I might just follow up on one thing in my response to Mrs. Kennelly on the Social Security, I am told that we do get 1099s for Social Security benefits in order to determine whether someone is subject to tax on benefits. I would like to correct my remarks on that point.

Chairman SHAW. Mr. Gibbons.

Mr. GIBBONS. Thank you, Mr. Chairman.

Let me ask you, Ms. Richardson, just what capacity does the IRS have? Can your machine read taxpayer return information to include the Social Security number? Can your machine read that or do you have to hand-read it?

Ms. RICHARDSON. Congressman Gibbons, today we are doing some scanning of tax returns. I believe we are doing some of the 1040 EZs. But by and large we are still locked into a system where if people file on paper, we keypunch in the data from the face of the return. For returns filed electronically the data is completely captured electronically and we do not have to transcribe the information.

Mr. GIBBONS. Now, once you get that data which most of it must be hand-punched in, I guess, can your computers identify correct

or incorrect SSNs for a person?

Ms. RICHARDSON. We have been able to do that this year. We have, as part of our fraud detection efforts, stepped up our ability to match SSNs, to check for duplicate numbers, and to assure that the names and the numbers match with what is on the Social Security records.

Mr. GIBBONS. You have only been able to do that this year?

Ms. RICHARDSON. We have done it this year.

Mr. GIBBONS. All the years prior to that you really could not do

it, is that right?

Ms. RICHARDSON. I think that is correct and then we made a concerted effort as part of our antifraud efforts to transcribe all the numbers and assure that not only the taxpayer and the taxpayer's spouse, but dependents were also transcribed and matched.

Mr. GIBBONS. Can your computers tell you whether taxpayer A and taxpayer Z are perhaps claiming the same child dependent?

Ms. RICHARDSON. We can do that this year. One of the reasons we slowed the refund process down was so that we could do a du-

plicate Social Security number check.

Mr. SAMUELS. Mr. Gibbons, if I could just add, because the IRS has that capability and they have been engaging in this matching this year, that is a reason why we strongly urge the Committee to consider our proposal to simplify dealing with taxpayers who do not provide correct Social Security numbers. The IRS does not have to go through complicated methods of denying EITC if someone does not provide a correct Social Security number.

We think that is a very important proposal and would greatly as-

sist us in our compliance efforts.

Mr. GIBBONS. I can see that the invention of false children and false dependents could be a real problem unless you have some way of identifying them other than off of some given name.

About the Social Security system, I guess it is the only way we

have got of doing that, the Social Security number.

Mr. SAMUELS. As you may recall, Mr. Gibbons, in the GATT, General Agreement on Tarriffs and Trade, legislation we have required that a Social Security number be obtained for all children, regardless of age. We are phasing that provision in.

Prior to the GATT change you were not required to have a Social Security number for a child under the age of one, and now we are requiring it for all children, on a phased-in basis, so that we will

have a complete file to match.

Mr. GIBBONS. You will not have those any time real soon. When will all that be effective?

Ms. RICHARDSON. 1997, in the next 2 years.

Mr. GIBBONS. 1997?

Mr. SAMUELS. Yes. Mr. GIBBONS. You mean for-

Mr. SAMUELS. Right now it is all children the age of one or older. Now we are phasing it in for children under the age of one. We wanted to make sure that the Social Security Administration had the ability to provide the numbers because we didn't want to have a requirement that people could not meet. Based on our discussions with the Social Security Administration we developed a phase-in schedule based on how old the child is. For tax year 1995, it is for any child 2 months or older, and then it is 1 month or older next year.

We phased it in to make sure that people could, in fact, get the numbers and that was one of our proposals that was in the Uruguay round legislation, which we think is quite important to

our compliance effort.

Mr. GIBBONS. Yes, I recall that.

Now, let me see if I am correct. In calendar year 1997, you will have a complete web, is that right?

Ms. RICHARDSON. In order to claim a child as a dependent or to claim a qualifying child for the EITC, that child will have to have a Social Security number no matter what age.

Mr. GIBBONS. You will be able to tell by that time whether one or more, two or more families are claiming that same child, is that

right?

Ms. RICHARDSON. That is correct. We are actually able this year to verify duplicate numbers. I believe that if a child under one did not have a Social Security number we required additional verification that the child was, indeed, who the taxpayer claimed before we allowed the credits to go forward.

Mr. GIBBONS. It will not have eliminated that potential loophole

until 1997, is that correct?

Mr. SAMUELS. Excuse me, what I understand, Mr. Gibbons, is that the legislation will be effective in tax year 1997, for all people. It is really in the filing season for 1997 returns we will have it.

With respect to periods before then, the IRS, as I understand the Commissioner's comments just now, is taking special measures for those returns where there are children under the age of one without a Social Security number. They are asking for additional information to fill the gap between now and the time we can do it all with the computers.

Ms. RICHARDSON. That is correct, Mr. Gibbons. I would say that that problem has been addressed this year. Although the requirement to have the numbers is not there until, or fully phased in until 1997, we are verifying before claims are allowed, that, indeed, the child belongs to the person, or it is a qualifying child or prop-

erly claimed as a dependent.

Mr. GIBBONS. Well, the reason why I try to get such detailed information on this is that it has long seemed to me and by information that I have picked up on the street as you wander around, that there always has been quite a game where dependency was a test of what you either owed or you got as a benefit.

There is a little faking in that area. I was trying to put it gently. They have been borrowing kids around and borrowing—I do not

want to claim it as fraud, but it certainly is fraud, I guess.

Ms. RICHARDSON. Well, one of the, perhaps salutary effects of what we have done this year is that we have 800,000 fewer dependents who were claimed this year over the same period last year.

Mr. SAMUELS. That is a very important point that shows the results of what the Commissioner has been doing. This year we have seen a decrease in the number of dependents and we have actually

seen a decrease in the number of returns filed by taxpayers with children which we did not expect. It is less than last year so it is less in absolute terms-

Mr. GIBBONS. Are you telling me that the Clinton administration

has reduced our roles of dependency by 800,000?

Ms. RICHARDSON. We have 1 million more returns that have been filed this year, at the same time, over last year. We have 800,000 fewer dependents who have been claimed this year on all returns, and then for EITC purposes the number of returns claimed that had people with qualifying children is down by about 257,000.

Yes, we feel that the steps we took this year, particularly those

involving verification of SSNs, have been effective.

Mr. GIBBONS. Well, I realize we have not killed any children or

anything like that.

Ms. RICHARDSON. We are not aware that there was any major illness, so we believe it has been attributable to our fraud efforts.

Mr. GIBBONS. Well, that is good.

Chairman Shaw. What I would like to add here is just a brief question along that same line. Why do we not just go ahead and require the Social Security number to be issued with the birth certificate? Everybody is going to need one, whether it be for a poverty program or later becoming a taxpayer. Why not just go ahead and give each child a Social Security number simultaneously with a birth certificate?

Mr. SAMUELS. Mr. Chairman, as I understand it, that will be the effect.

Chairman SHAW. Is that 1997?

Mr. Samuels. That is correct, that is 1997.

Chairman Shaw. Is that what is actually required in 1997, is that the Social Security number is-

Mr. SAMUELS. Yes, and so that will show up when we do——Chairman SHAW. Why do we phase that in, why do we not just

go ahead and do it?

Mr. SAMUELS. I think that we wanted to make sure that we were not putting parents of newborns in the position that all of a sudden they would be asked to do something, and the States who administer the registration of births could not deliver. There was just a great concern that no one wanted to put a requirement on people who would then bitterly complain because States had not worked out a way of actually producing the Social Security number.

As we were talking about this last year, among the staff, we would have somebody say, "Well, yes, my wife just had a child and we are still waiting for the number." That was the reason it was

phased in.

So, we think-

Chairman Shaw. Are we getting into a problem with an un-

funded mandate, though?

Mr. SAMUELS. No, I do not think so. I think that we just really needed people to adjust their systems and make sure the Social Security Administration can provide the information that the States need. The States are registering births anyway. It was just a matter of getting the systems, I think-

Chairman Shaw. Yes, they could probably use that as a filing

number themselves.

Mr. English, do you have any questions? Mr. ENGLISH. Thank you, Mr. Chairman.

Just briefly. I would like to thank the panelists for joining us today to participate. What we are doing today, I think is very important. Because the reevaluation of the design of the EITC is extremely timely right now. I think this program, this tax provision is very important for the working poor. It has enjoyed bipartisan support in the past.

It has a very important role in our discussions on other areas of public policy, such as welfare reform and changing the minimum

wage.

I think there are a number of issues here which you have already covered, including the inaccuracy—and I hesitate to use the word, fraud, but that is obviously a significant part of it—the inaccuracy of many forms that are filed—the marriage penalty which I think is a very significant issue and the question which Mr. Samuels has raised, ably here, on simplification.

I have a couple of questions. First of all, Mr. Samuels, has the Treasury looked at the marginal tax rates of people who are leaving poverty, who are leaving the welfare system to become working poor and take a low-paying job?

Can you give us any data on the marginal tax rates that they face?

Mr. SAMUELS. Mr. English, we have looked at that and we can provide you with some specific information. I would say that in evaluating the marginal tax rates there are two issues. As you move into a job, you would be giving up significant benefits if you were receiving assistance. A purpose of the EITC is to offset the marginal rates which are caused by moving off of welfare to work. Also, for example, once you start to work, your first dollar is subject to FICA tax.

When you are thinking about what you are giving up and what you are moving to, you have to worry about the first dollar being subject to the FICA tax. And then, at a certain point, you are subject to income tax.

A worker without qualifying children, for example, becomes subject to income tax below the poverty line. There are significant marginal rate problems for these low-income workers that are a concern. The EITC is supposed to help people by increasing their net wage and offsetting these marginal tax rate problems. It is the only program we have like that.

Mr. ENGLISH. I would welcome your specific information. Mr. Steuerle, who I believe is here to testify today from the Urban Institute, previously indicated that the marginal tax rate can be in the range of 85 percent or perhaps even higher under certain circumstances.

Was that the finding of Treasury?

Mr. SAMUELS. Well, let me just give you some numbers here. The food stamp phaseout rate is 24 percent. The AFDC phaseout rate is 66 percent during the first 4 months of employment and 100 percent thereafter. When you start adding these together you have very high margin tax rates.

Mr. ENGLISH. Your finding has been that the EITC plays a significant role in lowering that marginal tax rate and making it easier to move from welfare to work.

Mr. SAMUELS. Yes, we do.

Mr. ENGLISH. I noted in your testimony that you are opposed to lowering the investment income cap as proposed in the Senate bill on the grounds that it might discourage savings and might contribute to error.

Can you give us any hypotheticals on why you see that as a sig-

nificant problem?

Mr. SAMUELS. Mr. English, when we proposed an investment income limit we picked \$2,500, which was reduced in H.R. 831 to \$2,350. We tried to pick a number that we thought would improve targeting, but also not discourage a low-income family from saving for a first house or for medical emergencies, or for education for their children. As you know, we have a very serious problem of savings in this country. The Committee has had significant hearings on this. We are also very concerned about it.

What troubles us is that if you lower this cap down to \$1,000, you could hurt people who are trying hard to build a little nest egg. The cap, is also a cliff. If you have \$1,001 you lose all of your EITC. When we designed the \$2,500 proposal, we pointed out that there

is a cliff, and we do not like cliffs as a policy matter.

We were trying, as Commissioner Richardson said earlier, to have something that was simple, easy to understand and was not going to create more complexity that would, in turn, lead to errors.

With a \$2,500 cap, we tilted to no phaseout and a cliff. You can see the dramatic result for somebody if they had \$1,001 of interest from a savings account, some savings bonds, and they lose all their EITC. It is especially difficult for a population that probably does not keep that close a track on fluctuations in their investment income.

Mr. ENGLISH. Sure. And those points are well taken. Thank you, Mr. Secretary, thank you, Commissioner, and thank you, Mr. Chairman.

Ms. RICHARDSON. Thank you.

Chairman Shaw. Thank you, Mr. English.

That does conclude the questioning.

Yes, Mr. Gibbons.

Mr. GIBBONS. I do not mean to be monopolizing this question thing here.

Chairman SHAW. You go right ahead and then I will ask another

one, too.

Mr. GIBBONS. I am wondering if you could explain to me why we have put certain things in certain categories as far as what is income?

For instance, I am looking at—on page 8 of the form that you all have for this, and you have got a chart, on page 304, that shows what is income and what is not income for the EITC.

I have sat through these things for a long time and I have forgotten some of the reasons we use to get to where we are. Maybe you can refresh my recollection.

It seems to me that food stamps are just as much income as cash is. Why did we not classify food stamps as income?

Mr. SAMUELS. Well, Mr. Gibbons, I think that the answer, at least in my mind, is clear. The level of food stamps was set, with the notion that it was not taxable income. If you wanted to tax it, then you ought to take that into account when setting food stamp benefit levels.

That program was established without the notion that that amount is income. In addition, you have a phaseout of food stamps. You have in effect a marginal tax rate for food stamps. As I recall, it is 24 percent. As your earned income goes up, you lose 24 cents on the dollar.

We, in effect, are taxing, through the phaseout, the food stamp amounts already. It seems to me it would be inappropriate, in effect, to hit it twice.

I think that that was the reason why food stamps were not included. Apart from the fact that then we would have to figure out how much they were, who they were given to, and Commissioner Richardson would have a very difficult time in trying to determine, if one theoretically wanted to try to include food stamps, who, in fact—

Mr. GIBBONS. Well, I realize technically it would be a tough problem, particularly since you are just learning how to check SSNs. It seems like to me that I can go down here to Safeway in Southwest Washington, there are a lot of food stamps used there. I go through the line with them and their food stamps are just as much money as my dollar bills are money.

So their food stamps are not taken into consideration at all in

family income for the EITC?

Mr. SAMUELS. No, sir. As I was saying, if you wanted to do that, you would have to take account of one, that they are, in effect, subject to a tax because they are phased out. You lose 24 cents on the dollar.

Mr. GIBBONS. I realize that.

Mr. Samuels. But, two, if you wanted to do that, you would have to say to yourself, well, should I increase the food stamp benefit—I mean on what level do you want to have people receiving food stamps? As you know, in order to bring a family of four, with a fultime worker earning the minimum wage, out of poverty they need food stamps, they need the minimum wage—not today's minimum wage, but they need a minimum wage that has been increased as the President has proposed by 90 cents—and they need the EITC. They need all three of those so that a family of four with a fultime worker earning the minimum wage can be out of poverty.

If you want to include food stamps in income, and if you believe that is an appropriate objective for full-time workers to have incomes above the poverty level and we certainly do, then you are going to have to increase the EITC or you are going to have to do

something to make up the difference.

As I said, that goal right now is not met. We are not with the current system. With today's minimum wage, today's food stamps and today's EITC—we are not bringing that family of four with a full-time worker at the minimum wage out of poverty.

Mr. GIBBONS. I understand that. I am not arguing with you about that. Just looking over this list, on page 304 of the form book, a lot of it does not appear to make a heck of a lot of sense

as far as equity is concerned between citizens. You know, I have taken up more time than I should have here. Perhaps I ought to have a private conversation with you and with my staff to argue about why we have classified this thing as we have.

Mr. SAMUELS. Mr. Gibbons, we would be pleased to sit down and

go over that with you and your staff.

Chairman SHAW. I believe that we should take another look at it. I would, Mr. Samuels, direct your attention to page 269 of the Tax Guide for 1994, which provides for a number of things that are not included. For instance, taxable items such as alimony.

The chart I am looking at may be wrong, but you will have to

take that up with Ms. Richardson. I did not write it.

Mr. SAMUELS. Mr. Chairman, alimony is included for adjusted gross income purposes, not earned income purposes. If you are receiving a substantial amount of alimony and let us say that you

had small earned income but a lot of alimony—

Chairman SHAW. Well, if we go back—I do not want to belabor the point, because it either is or it is not—but when we were talking before it was a question of adjusted gross income. I am not trying to get in an argument with you but I am saying, I am following up on what Mr. Gibbons said. To me these items that are listed on page 269, interest and dividends, Social Security and railroad retirement benefits, welfare benefits including all of them, pensions or annuities, veterans benefits, workmen's compensation benefits, alimony, child support, unemployment compensation, taxable scholarship or fellowship grants that were not reported—well that one, I can see where we may not want to include that—variable housing allowances for military. I think all of that goes into somebody's standard of living.

That is what we are trying to do with the EITC, make it so that we do not have working poor. I think that most of these items should be taken into consideration. I realize there are going to be some reporting problems because many of these do not go on the income tax returns. Perhaps this is something we ought to take another look at and I think Mr. Gibbons is quite correct in bringing this up.

Mr. SAMUELS. Mr. Chairman, we would be pleased to work with you on that. If I could just say that the EITC is a credit based on your earned income. There is a phaseout limit which puts all these other items—

Chairman Shaw. That is correct, but the purpose behind it was to eliminate the term, "working poor," because Congress feels—both Democrats and Republicans—if you are working you should not be poor.

Mr. SAMUELS. Right.

Chairman SHAW. So we should take everyone's resources into consideration in deciding whether they are poor. Your problem is compliance, and I understand that and perhaps we can work together to make a few midcourse adjustments on that.

I thank this panel very much. We kept you for an extraordinarily long period of time. You have been very cooperative with us, and we very much appreciate the time you have given us this morning.

Ms. RICHARDSON. Thank you, Mr. Chairman.

Chairman SHAW. The next panel we have includes: Marvin Kosters, a resident scholar of the American Enterprise Institute in Washington, DC; Robert Greenstein, executive director of the Center on Budget and Policy Priorities in Washington, DC; Mr. Eugene Steuerle, senior fellow of the Urban Institute of Washington, DC; Karl Scholz, Ph.D., associate professor, Department of Economics, University of Wisconsin; Jonathan Forman, professor, College of Law, University of Oklahoma. Welcome.

We have each of your written statements. You may proceed as you see fit. If you care to summarize, that would be fine, because

we do have your statements up here at the desk.

Dr. Kosters.

STATEMENT OF MARVIN H. KOSTERS, PH.D., RESIDENT SCHOLAR, AMERICAN ENTERPRISE INSTITUTE, WASHINGTON, DC

Dr. KOSTERS. Thank you, Mr. Chairman.

I appreciate this opportunity to be here and say a few words about the EITC. Much has been said about its growth and about the problems that are associated with it. It seems to me that this is a good time to take a look at it to see whether, this is a good way to spend as much money as is scheduled to be spent on it, and to see whether some of the problems really need to be fixed anyway.

There are several issues that I cover in my testimony. Just to summarize, take first the problem of fraud. It has received a good deal of discussion here, but I think that we need to recognize that there is more involved here than simply fraud. The high subsidy rate that can encourage work also encourages token work. Filling out the payroll tax forms and paying those, makes it legal, essen-

tially.

You will have, when it is fully phased in next year, a subsidy rate up to about \$10,000 of earnings of 40 percent compared with a payroll tax—a combined payroll tax rate—of a little more than 15 percent there will be incentives there to exchange work, for example, or perhaps just do the paperwork for it. Such arrangements will be difficult for the IRS to ferret out. No matter how much in the way of increased enforcement is put in place, it would be hard to identify such arrangements or do something about them. There is also the marriage penalty problem and, finally, there is the work incentives issue.

The first thing I would say about the EITC, as it is scheduled to go into place next year is that the cutoff quite high in relation to incomes of the families that are talked about in terms of the working poor.

Some 40 percent of families would be below the income cutoff next year when the EITC is phased in, and families with children; and this can be compared to a poverty rate of less than half that

in 1993, about 18.5 percent.

The income cutoff is quite high in relation not only to family incomes, but it is even higher in relation to the typical earnings of an individual worker. If you take workers as a whole, across the country, almost 50 percent of them earned less than \$25,000 in 1993.

Now, the main rationale for the growth and popularity of the EITC seems to be that it encourages work. I think it is useful to take a somewhat closer look at that. I believe that the favorable effects on work have been exaggerated and the reason is simply because so many, so far up the income distribution are encouraged to work less rather than more.

We have, for those 40 percent of families with children who are below the income cutoff, 20 percent, or half of that group below the income cutoff, work is fairly significantly discouraged. The real question is whether that 20 or 30 percent who are discouraged or not encouraged to work, would be offset to any significant extent by the 10 percent where no one is working but where someone might be encouraged to consider work. There is some evidence of that, that Professor Scholz has developed, I read that evidence as

saying, roughly, "maybe."

It seems to me that we need to recognize that the EITC discourages work for many families. For some families where work is discouraged, their incomes are likely to be actually lower after their EITC payment than it was before. If we take Professor Scholz' numbers, for example, and if we suppose that hours of work will increase as much as he estimates for people who are encouraged to work, we need to recognize that the amount of output, the amount of GDP, is still likely to decline. This is because the wages of those drawn into the work force are likely to be lower, significantly, lower than the wages of those further up the income distribution where there is likely to be a net discouragement of work.

It seems to me that the EITC should be looked at carefully we should see whether its administration ought to be transferred to a welfare bureaucracy that is already in place, and to see whether the subsidy rate should be very sharply cut back to say, the 15- to 20-percent range. Some of the income support payments might then be transferred to a welfare bureaucracy to administer and, perhaps, some of the rest could be used to reduce deficits in the future.

Thank you, Mr. Chairman.

[The prepared statement and attachment follow:]

Testimony of

Marvin H. Kosters American Enterprise Institute

Committee on Ways and Means Subcommittees on Oversight and Human Resources U.S. House of Representatives June 15, 1995

Improving the Earned Income Tax Credit

Mr. Chairman and members of the Committee: Thank you for this opportunity to give my views about the earned income tax credit (the EITC) and how it could be improved.

The EITC has become a major income transfer program. It redistributes income to low-income people who work, with most of its payments going to workers with dependents. Since it began in 1975, the program has been greatly expanded, most recently in 1993. Provisions enacted then will not be fully phased in until next year. By that time, its cost will have almost quadrupled since 1990.

The argument most frequently made for redistributing income through the EITC is that it encourages work. Although some are encouraged to work by the EITC, others face incentives to work less and their numbers have increased as the program has grown. In addition, the expansion of the EITC has led to higher marriage penalties and increased incentives for uneconomic activities and fraudulent claims. For these reasons, I believe the earned income tax credit should be scaled back sharply. Some of the payments now being made under the EITC to the poorest working families could better be administered by agencies responsible for other income maintenance programs.

The Scope of the EITC

The projected cost of the EITC in 1996 is \$26 billion in budget outlays and offsets to personal income tax payments. This is roughly comparable to the costs of food stamps (\$27 billion) and housing assistance (\$27 billion). The cost of medicaid is much larger (\$96 billion). The federal share of family support payments (AFDC) is considerably smaller (\$18 billion), but when state and local expenditures are included the total is somewhat larger (about \$33 billion). The EITC has become a major component of total federal expenditures to redistribute income to families with low incomes

A brief description of how the EITC works is necessary to discuss its effects. I will describe its application to a family with two dependents when current law is fully phased in next year. At incomes of up to about \$8,900, the credit provides a subsidy of an additional 40 cents for each dollar earned, up to a maximum credit of about \$3,560. Families in the relatively narrow income range between \$8,900 and \$11,600 are eligible for the maximum credit. The credit is reduced by 21 cents for each additional dollar earned where the credit is phased out in the income range between about \$11,600 and \$28,500. Families with one dependent receive a smaller maximum credit and are subject to correspondingly lower subsidy and phase-out rates. Low-income workers without dependents are also eligible for a small credit, but I will not discuss how they are affected.

Eligibility for the EITC of families with children depends on their income level and work status. The data that I use to see how many families are affected and how they are affected are from the Current Population Survey. This information on households with children that are likely to comprise tax filing units is shown in the table at the end of this statement.

A large share of families with children have incomes below the EITC income cutoff level according to these data. About 40 percent of families with children have incomes low enough to qualify for EITC payments. This 40 percent who are eligible for the EITC on the basis of their income level can be compared with a poverty rate for families with children of 18.5 percent in 1993. Payments under the EITC evidently extend to families with incomes well above the working poor as defined by the conventional measure of poverty. The families in these two bottom income

quintiles in which someone is working are directly affected by the EITC. The families in the other three quintiles are affected indirectly by the need to pay higher taxes to finance the EITC payments.

Effects on Work

To examine the effects of the EITC on work incentives, it is necessary to distinguish further between families by their work status and income level. Families with someone already working and with income in the range where they are eligible for the EITC account for 30 percent of families with children. These families are eligible to receive credit payments without any change in their work behavior. The program may induce them to modify their work choices, however, and the work incentives they face depend on their income levels.

For families with the lowest incomes -- up to \$8,900 for families with two or more dependents -- the amount of the credit increases as they work more and earn more. For every dollar they earn they receive a 40 cent subsidy in addition, and they are accordingly encouraged to work more through this "substitution effect." However, the credit payment they receive would permit them to maintain or even increase their income without working as much, and this "income effect" discourages work. Thus despite the large subsidy to their wages, the increased income they receive reduces pressure to work more. Whether they will work more or less depends on how their work behavior responds, and the evidence suggests that the net effect of these offsetting forces is likely to be quite small. These working families with the lowest incomes account for about 7.4 percent of all families with children (as shown in the table), and they are likely to experience little net work encouragement or discouragement.

Families with somewhat higher incomes receive the maximum credit in an income range that includes an additional 3.8 percent of families. They receive no additional encouragement to work through the substitution effect, while the additional income they receive from the credit produces an incentive to work less. Families in this income range will tend to work less.

For families with still higher incomes, where the credit is being phased out, the reduction in the amount of the credit payment as they earn more money is equivalent to an additional tax on earnings. For every additional dollar they earn, 21 cents are in effect taxed away by a reduction in their credit payment. For them, work is discouraged both by the reduction in net earnings from additional work, and by the additional income from the credit payment they still receive; the (negative) substitution effect is reinforced by the income effect. Families in this income range face the strongest incentives to work less, and they account for about 19.5 percent of all families with children.

Studies that have examined the implications of the EITC among working families generally conclude that their work effort is likely to be reduced compared with work behavior in the absence of the program.² Less work and lower earnings offsets some of the effect on incomes of EITC payments. Indeed, the evidence suggests that many working families eligible for the EITC will actually have lower incomes than they would have in the absence of the program.³

In view of this discussion of work incentives for families with someone working, what is the basis for the view that the EITC encourages work? Low-income families with no one working are unambiguously encouraged to work by the EITC. For them, the EITC amounts to a bonus for working as long as their income remains below the eligibility cutoff, but they receive credit payments only if they are induced to work and generate earnings. Although the EITC definitely has a positive effect on work incentives among these families, they account for only about 10 percent of all families with children.

Whether work is on balance encouraged by the EITC depends on whether enough people in the 10 percent of families with no one working choose to work, and to work enough, to offset the reduction in work effort expected for the 30 percent with someone already working. More than twice as many families face work incentives that definitely discourage work compared with those who are encouraged to consider working. Is it likely that less work in response to negative work incentives among working families could be offset by greater incentives to work among families with no one working? One study that examines the question concludes that fairly generous assumptions about work choices are necessary for the EITC to actually encourage work instead of on balance discouraging work.

Can anything be done to improve the balance? In my view, the EITC discourages work for too many families, too far up the income distribution. Family income cutoffs are quite high in relation to earnings of the typical worker. For example, among adult high school graduates (25 years old or more), half earned less than \$18,000 in 1993, and half of college graduates earned less than about \$31,000. For all adult workers, 57 percent earned less than \$25,000 in 1993. Credit payments under the EITC extend farther up the earnings scale than can reasonably be viewed as covering only the working poor.

Reducing the maximum amount of the credit, reducing the income limits for eligibility for the credit, and reducing the subsidy and implicit tax rates would reduce the number of working families for whom work is discouraged, while the number of low-income families with no one working -- and who would be encouraged to consider working -- would be unchanged. Downsizing the EITC would reduce the strength of positive work incentives for families with no one working, but negative work incentives for families with someone working would be correspondingly reduced, and work would be discouraged for fewer families. In addition, of course, less income would be redistributed, and the transfers that remained would be shifted toward lower income families with children.

Reducing the income cutoff level and phasing out payments more quickly is another approach that could be considered. But unless the size of the maximum credit were also reduced, this would increase the implicit marginal tax rate on earnings and strengthen incentives to cut back on work for the remaining families. If the credit payment is large, there is really no escape from the dilemma of a punitively high implicit tax rate or extension of payments to a large number of families higher up the income distribution.

The Marriage Penalty

It has long been recognized that tax liability under the individual income tax is often higher for two individuals who are married than it would be if they were single instead. Under a personal income tax system with progressive marginal tax rates and equal taxation of married couples with the same incomes, complete marriage neutrality cannot be achieved. Until recently, however, marriage penalties have not been a problem for families with relatively low incomes because they either paid no taxes or their tax liabilities were small and rates were very low. The EITC brought the marriage penalty to low-income families, and the big expansion of the credit in the 1990s made it a significant problem.⁵

The marriage penalty is particularly severe for people who -- if they were not married -would each be eligible for the maximum credit. Under the most adverse circumstances the marriage
penalty could amount to over \$5,000, which for the family affected would be about 25 percent of
the combined income of the married couple. Such a tax penalty creates an economic disincentive
for marriage, and it reduces economic rewards from employment for married secondary workers
compared with their unmarried counterparts.

The marriage penalty could be reduced by introducing a two-earner credit, based on the same logic as the two-earner deduction in the individual income tax law from 1981 to 1986. This would, of course, increase the cost of the program. The problem could also be ameliorated by reducing the size of the EITC. A significant reduction in subsidy and phase-out rates and in the maximum credit amount would greatly reduce the importance of the marriage penalty.

Incentives for Waste and Fraud

The high subsidy rate for earnings at low family incomes produces incentives to engage in both legal and illegal activities to take advantage of payments under the EITC program. Because the earnings subsidy rate very substantially exceeds payroll tax liabilities, the EITC makes some work attractive that would not otherwise be undertaken. In other words, it encourages activities that could be characterized as taking in one another's laundry when doing one's own would make more sense. Activities of this sort could be perfectly legal, but they would contribute little to economic well-being and mainly produce transfers for EITC recipients.

The rewards produced by credit payments and subsidy rates that are high in proportion to income have also apparently stimulated illegal activities. Audits by the IRS have shown a high incidence of credits claimed that are in excess of amounts for which families were eligible, and

many credit payments for which families were ineligible. Efforts have been made to make the program more easily administrable, and this might help to reduce errors. But the subsidy rate and the size of credit payments have also been increased substantially, increasing incentives to make fraudulent claims.⁶

The primary function of the IRS is collecting tax revenue under a system that is largely self administered. Assuring compliance with EITC provisions poses some awkward problems for a tax collection agency. Its activities are oriented primarily to identifying hidden or under-reported income, not to looking for ways in which income from earnings might be exagerated. Earlier tax reforms removed many low-income families from the tax rolls, but the EITC has swept many low-income families back in. Auditing these returns, each with a relatively small dollar amount at stake, is quite expensive in relation to the revenue impact of errors and noncompliance that are identified. The IRS may also be reluctant to press too hard to recoup overpayments, and it may find them very difficult to collect. Yet, unless reasonable compliance can be assured, the IRS is likely to be seriously embarrassed and the EITC program discredited.

In considering the auditing and compliance role of the IRS for the EITC, it should be recognized that a large bureaucracy to administer welfare payments and other social services is already in the field. This bureaucracy is often criticized for devoting too much attention to documentary paperwork and auditing, and too little to counseling and helping families in other ways to improve their circumstances. It makes little sense in this context to establish a separate, parallel bureaucracy in the IRS to administer another program to supplement incomes of low-income families, many of whom also receive benefits under other programs.

As in the case of work incentives and the marriage penalty, the compliance problem is greatly exacerbated by the size of the EITC. Smaller subsidy rates and credit payments would reduce incentives to claim credits to which a family is not entitled. If the size of the EITC were significantly reduced, whether the beneficiaries received partial payment of their estimated credit contemporaneously with their paycheck, or in a lump sum at the end of a tax year (as most now choose), would also be a matter of less consequence.

Summary

The major problems with the EITC have become more significant as the program was expanded. Although intended to encourage work by helping to "make work pay," the EITC discourages work for too many, too far up the income distribution. As it is currently structured, the EITC also imposes a significant marriage penalty on low-income working people. And serious compliance problems have become evident in administering the EITC. All of these problems would be greatly ameliorated by making the EITC less generous.

Since payroll taxes absorb a significant portion of earnings for workers with low incomes, a strong case can be made for relieving those with the lowest incomes from the burden of these taxes while maintaining comprehensive program coverage. An EITC that is significantly more generous, however, introduces more disincentives to work, builds up a significant marriage penalty, and invites fraud. I believe that we have expanded the program too much and that we are now placing too much reliance on the EITC under the guise of improving incentives to work.

I think the EITC has become too generous and should be cut back to its size in the early 1990s, before it was most recently expanded. I do not argue that income transfers to families with the lowest incomes should necessarily be reduced, but the total cost of income maintenance programs could be reduced significantly without reducing payments to low-income families with children. The goal of providing income support to families with the lowest incomes would be better served by scaling back the EITC and placing more reliance instead on other income support programs. These other programs should also be reformed, of course, to place more emphasis on making work a condition for eligibility when this is appropriate.

Endnotes

- 1. Income levels for the EITC are indexed for inflation. The estimates reported are from Reducing Entitlement Spending, Congressional Budget Office, September 1994.
- For example, Earned Income Credit: Design and Administration Could be Improved, U.S. General Accounting Office, September 1993; "The Earned Income Tax Credit: Participation, Compliance, and Antipoverty Effectiveness," John Karl Scholz, National Tax Journal, Vol. 47, No. 1, 1994; "Promoting Work through the EITC," Janet Holtzblatt, Janet McCubbin, and Robert Gillette, National Tax Journal, Vol. 47, No. 3, 1994; and "The EITC and the Working Poor," The American Enterprise, Marvin H. Kosters, May/June, 1993.
- 3. "Effects of the Earned Income Tax Credit on Income and Welfare," Edgar K. Browning, National Tax Journal, March 1995.
- 4. "The Earned Income Tax Credit and Transfer Programs: A Study of Labor Market and Program Participation," Stacy Dickert, Scott Henser, and John Karl Scholz, paper prepared for NBER Tax Policy and the Economy conference, November 1994.
- 5. It should be recognized that under some circumstances the EITC can give rise to a marriage bonus. I do not regard that as a problem. From the point of view of socio-economic indicators, marriage is one of the most common ways in which families move off of welfare and out of poverty. For extensive discussion of the marriage penalty, see "Alleviating Marriage Penalties in the Income Tax and the Earned Income Tax Credit," Anne L. Alstott, <u>Tax Notes</u>, February 27, 1995.
- Earned Income Credit: Targeting to the Working Poor, U.S. General Accounting Office, March 1995.

Table

Effects on Work Incentives and Proportions of Families
Affected by the Fully Phased in Earned Income Tax Credit

Families with children	Percent of	Effe	ects on Work Incenti	ives
by Income Range and	Families	Income	Substitution	Total
EITC Eligibility	with Children	Effect	Effect	Effect
All Families with Children				
38,895 thousand	100%			
Familia wish Issaess Tax High				
Families with Incomes Too High for Eligibility for the EITC				
23,163 thousand	59.6%	0	0	0
23,103 mousand	39.0%	U	U	v
Families in Income Range				
Eligible for the EITC				
-Families with Someone Work	ing:			
 Income Range Where Cr 				
Phased Out (Credit Paym				
Declines as Income Incre				
7,594 thousand	19.5%	-		_
Income Range Eligible for	or the			
Maximum Credit Paymer				
1.489 thousand	3.8%	_	0	_
1,707 110434114	5.0%		v	
• Income Range Where Cr	edit is			
Phased In (Credit Payme				
Increases as Income Incre				
2,871 thousand	7.4%	_	+	?
• • • •				
-Families with No One Working	ng:			
Eligible for Credit if Son	neone			
Decides to Work				
3,774 thousand	9.7%	+	+	+
23		•	•	

Source: Estimates are based on the March, 1992 current population survey data reported in <u>The Earned Income Tax Credit EITC</u>, <u>Current Law and the Clinton Proposal</u>, Thomas Gabe, Congressional Research Service, May 25, 1993. The assumptions used to develop these labulations differ in several ways from circumstances that will prevail in 1996, but these differences are not likely to affect estimates of proportions of families very much because both family incomes and thresholds for EITC eligibility move up proportionately with inflation.

Chairman SHAW. Thank you, Dr. Kosters. Mr. Greenstein.

STATEMENT OF ROBERT GREENSTEIN, EXECUTIVE DIRECTOR, CENTER ON BUDGET AND POLICY PRIORITIES, WASHINGTON, DC

Mr. Greenstein. Thank you, Mr. Chairman.

I think as the hearing is making clear this morning, probably the principal issue that needs to be addressed in the EITC is the question of error rates. We should be mindful, both of the progress that

is made and of how far we still need to go.

I think Congresswoman Johnson mentioned some of the studies done in the eighties. I think the most recent studies, one of them released just last week, suggests that where we are now is that we have cut the error rate or the Service has cut the error rate about in half from where it was when those studies were done in the eighties. It is still too high and we have a way to go. I am not going to go into detail here, but perhaps during the questioning period, if you are interested I could go through the studies that I think indicate we have roughly cut the error rate in half but we have a further amount to go.

Well, the GAO, General Accounting Office, by the way, has also noted some of that progress in reducing errors. But, I think, part of the discussion here of the EITC and of the growth in the credit, which Congressman Gibbons referred to, is to discuss why the

Congress, on a bipartisan basis, has expanded the credit.

The growth of the credit is closely related to erosion in wages for low-paid work. What this board shows you is that since the late seventies the poverty rate for families with children in which a parent works has gone up nearly 50 percent. When wages for low-skilled work erode this not only reduces living standards and increases child poverty, but it lessens incentives to work and it lessens the gains from working relative to receiving welfare.

As a result of that, starting in the mideighties, there was a bipartisan policy emphasis here, in Washington, of increasing the returns from low-paid work with the EITC as the principal policy instrument for doing that. It was started by President Reagan who proposed a large expansion in the EITC that was part of the Tax Reform Act of 1986, President Bush proposed another large expansion in the late eighties that was in the 1990 budget agreement, and then President Clinton in 1993.

These expansions of the credit basically reflected a policy shift away from the minimum wage and away from welfare and to the EITC instead. As you know, the minimum wage is at its second

lowest level in purchasing power in 40 years.

What is less well known is the following fact. In the early seventies, before the EITC existed, the number of States in which a mother with two children, who worked and earned wages equal to three-quarters of the poverty line, in which she got welfare as a supplement to her wages was 49. Today it is three.

We basically do not provide AFDC to these families any more, we have moved them out of the welfare system. We have had the minimum wage erode, we have greatly expanded the EITC instead.

These were conscious policy choices.

The credit was also expanded in part to offset the payroll tax. It increased in 8 years out of 11, between 1980 and 1990 and the excise tax increases of both 1990 and 1993.

The EITC expansions were also designed to obtain a goal that has broad bipartisan support that if a parent works full time, year-round, the parent should not have to bring up the children in pov-

erty.

One of the first places this was written down was actually in a volume the Heritage Foundation published in January 1989 to guide President Bush when he came in. Heritage called for expanding the EITC enough to bring families of four with a full-time worker to the poverty line without raising the minimum wage. That essentially has been the thrust of these policy expansions.

As a result of that, as Assistant Secretary Samuels said, these expansions really were not out-of-control growth. They were not an anticipated growth. Once the 1993 expansion fully phases in, the credit drops to about a 4-percent-per-year growth rate which is inflation and population growth.

If the Bureau of Labor Statistics modifies the consumer price

index, the EITC growth rate would drop a bit further.

The final point on this issue is that these expansions in the credit do not look quite so large when you put them in the context of what happens to the minimum wage and to the EITC and to AFDC. What this board shows you is that if you take a mother with two children who works 20 hours year-round at the minimum wage to 40 hours—anywhere from half time to full time year-round at the minimum wage—her disposable income today, when the EITC expansion passed in 1993 fully phases in, is \$1,500 to \$3,000 lower than it was in 1972, before the EITC was created.

The reason is that the withdrawal of AFDC and the erosion of the minimum wage and the increases in the payroll tax more than balance out the entire EITC.

This is a reason both why I think in reforming the credit we need to be very careful not to do things that make the gain from working less, and the gains from working relative to welfare less. I think that means not scaling back the 1993 expansion, not deindexing the credit. It is also the reason why Governors, like Governor Engler in Michigan, and Governor Carlson in Minnesota—both of whose welfare commissioners I have talked to in the last week or so about this—both regard the EITC and the EITC as passed in 1993 as a very important part of the welfare reform to move families to work that they are trying to implement in their States.

A couple of quick words on the work incentive point that Dr. Kosters has raised. I also think the work incentive point needs to be looked at carefully in terms of who the people are that the EITC encourages to work more and who it may encourage to work less.

As Dr. Kosters just noted, and I think as Congresswoman Johnson noted earlier, the economic literature suggests that people whose earnings are in that range from zero up to about \$8,900 are encouraged to work more because as they work more their credit goes up and that there may be encouragement to work a bit less where the EITC line is coming down.

However, as Bob Reischauer, the CBO Director, noted in 1990 and as virtually every study on this issue has found, the principle

group who is encouraged to work less are secondary earners in twoearner families. In nontechnical terms, the additional income the EITC provides enables some mothers in two-parent working families to choose to spend more time with their children.

That is the principal work discouragement of the EITC. As

Reischauer noted, that is not necessarily an adverse policy.

Finally, the studies that Marv referred to and I think the Congresswoman referred to, most of them only covered the effect of the credit on people who were already working. New studies, which I guess Professor Scholz will talk about, also look at, for the first time, the effect of the credit on people who otherwise would not work at all, and find that it brings a significant number of them into the work force.

In summary, on the work incentives, we have people who otherwise are not in the work force at all encouraged and brought into work and brought into the labor market; people, primarily single parents, working very little, encouraged to work more; and primarily secondary earners, mothers in married, two-parent families enabled to spend a little more time with their children.

I do not think you can simply lump those altogether, and say the effect is not positive. There is a similar issue—which I am out of time so maybe I will cover during the questions—on the marriage penalty. In two sentences, it is a marriage penalty for two earners

thinking about marrying each other.

The EITC also provides a big marriage bonus for welfare mothers who, otherwise when they marry, they lose all their welfare, they may lose all their Medicaid. But if a nonworking welfare mother marries a guy at a \$10,000 or \$12,000 wage neither can get a major EITC now. They marry and they qualify for the first time. He is earning and she has kids and it actually greatly lessens the disincentives to marry otherwise in the welfare system.

Again, we got to be careful. It is a marriage penalty for some, that is a problem. It is a marriage bonus for the group most want to encourage to marry, people who can get off welfare by getting married and are, without the EITC, discouraged from doing so.

The last point I want to make is that there has been some discussion of the workers without children. Before Congress extended the small credit to workers without children in 1993, the CBO data shows from 1980 to 1993, the Federal tax burdens of the poorest one-fifth of nonelderly households without children jumped 38 percent. The reason was that those eight payroll tax increases and several excise tax increases for families with children were offset by expanding the EITC. The tax burdens of workers without children went through the roof. The 1993 extension of a small credit to workers without children, was designed to help offset that, if we are concerned about having very high Federal tax burdens on any low-income workers, those with children and those without.

Thank you.

[The prepared statement follows:]

TESTIMONY OF ROBERT GREENSTEIN, EXECUTIVE DIRECTOR CENTER ON BUDGET AND POLICY PRIORITIES

House Committee on Ways and Means: Subcommittees on Oversight and Human Resources June 15, 1995

I am executive director of the Center on Budget and Policy Priorities, a non-profit public policy organization that examines federal and state fiscal policies with an emphasis on policies affecting low- and moderate-income families. Funded by foundations, the Center has been engaged in analyzing issues related to the earned income credit for a number of years. Last year, I also served as a member of the Bipartisan Commission on Entitlement and Tax Reform. In my testimony today, I would like to make several points.

- Progress in reducing EITC errors was made in the 1990 reconciliation bill, but more
 needs to be done. This year, the IRS has taken some badly needed steps that appear to
 be producing significant error rate reduction. Legislation the Treasury Department
 submitted with the budget also should help reduce errors. Efforts are needed to
 identify additional steps to lower error rates.
- While seeking to reduce EITC error rates, we should be mindful that the EITC has major strengths. It addresses a key trend that has caused a substantial increase in child poverty in recent years, the erosion of wages for low-paid work. The EITC also helps substantially in making work more remunerative than welfare. It is an important building block for welfare reform that places some limitations on cash assistance and seeks to move families to work.
- Certain reforms in the EITC eligibility structure are desirable. The imposition earlier
 this year of a "wealth test" on the EITC was a sound move. Consideration should be
 given to counting some additional types of income in determining whether a filer
 meets this test if doing so would not add too much complexity. Proposals to bar EITC
 receipt for tax filers in which either the parent or the qualifying child is residing here
 illegally also should be enacted.
- Some proposals, however, need to be regarded with considerable caution and would be unwise. A proposal to end the indexing of the EITC would cause large increases over time in the tax burdens of millions of low-income working families whose wages are simply keeping pace with inflation; it also would conflict with the goals of work-based welfare reform. Rolling back the EITC changes enacted in 1993 would be undesirable as well, reducing the advantages of work over welfare, making it more difficult for workers to escape poverty, and raising tax burdens for some.

The Basis for the EITC

The need for, and growth of, the EITC in recent years is closely related to the erosion of wages for low-paid work. Between 1977 and 1993, the poverty rate for families with children in which the family head works grew by nearly half. In 1977, some 7.7 percent of such families were poor; by 1993, some 11.3 percent were. More than 60 percent of all poor families with children contain a worker. In addition, Census data show that the proportion of full-time year-round workers paid a wage too low to lift a family of four to the poverty line rose by one-third between 1979 and 1993, from 12 percent of full-time year-round workers in 1979 to 16 percent in 1993.

Eroding wages for low-skilled work reduce living standards and increase child poverty. They also lessen incentives to work and decrease the gains from working relative to receiving welfare. Starting in the mid-1980s, these trends led to a bipartisan policy emphasis on increasing the remuneration from low-wage work, with the EITC as the principal policy instrument for accomplishing the task.

President Reagan proposed a major EITC expansion in 1985, which was included in the 1986 Tax Reform Act. Congress passed a further expansion in 1990, with support from the Bush Administration. President Clinton proposed a final expansion that Congress passed in 1993.

These expansions signaled an increased reliance on the EITC and a decreased reliance on the minimum wage as an instrument of wage policy. The purchasing power of the minimum wage is now at its second lowest level since 1955. Next year, it will be at its lowest level since 1955.

These expansions also reflected another policy shift — the EITC has supplanted AFDC as a means for supplementing the wages of poor single parents with children. In 1972, before the EITC was created, 49 states provided AFDC as a wage supplement to a mother with two children whose

earnings equal 75 percent of the poverty line. Today, just three states do. Policymakers have largely opted to move these families out of the welfare system and instead to reward their work effort through the EITC.

The EITC expansions also were designed to help offset the effects of a series of increases in the payroll tax. One of the EITC's purposes has always been to help offset regressive payroll taxes. Payroll tax hikes took effect in 1980, 1981, 1982, 1984, 1985, 1986, 1988, and 1990. Similarly, the EITC expansions also were intended to help offset increases in regressive excise taxes. Excise taxes were most recently raised in 1990 and 1993.

Finally, the EITC expansions were designed to attain a goal that has enjoyed strong bipartisan support — that if a parent works full-time year-round, the parent should not have to raise his or her children in poverty. This goal has been espoused across the political spectrum. For example, the volume that the Heritage Foundation published in January 1989 to guide the incoming Bush Administration called for expanding the EITC sufficiently to bring families of four with a full-time worker to the poverty line.

Specifically, this goal is that wages from full-time year-round work at the minimum wage (net of payroll taxes) should lift a family of four to the poverty threshold when combined with the EITC and food stamps. When the 1993 EITC expansions are phased in fully, the nation will be close to attaining this goal and would reach it with a modest increase in the minimum wage.

EITC growth rates over the past decade thus do not reflect unanticipated cost increases; the rate of recent EITC growth is due to explicit policy decisions by Congress and three Presidents to expand the credit for the reasons just cited. Nor do the recent growth rates signify that the program is spinning out of control. The CBO and Joint Tax Committee forecasts show that once the EITC expansions phase in fully by fiscal year 1997, EITC growth will slow sharply to a little more than four percent per year, with that remaining growth being due to inflation and growth in the U.S. population. Moreover, the EITC growth rate will be smaller than this if the Consumer Price Index is modified in a fashion that reduces the measured inflation rate. Even without changes in the CPI, the CBO forecast indicates that as a percentage of the Gross Domestic Product, EITC costs will decline after 1997.

Moreover, the EITC expansions do not look quite so large when placed alongside the nearelimination of AFDC as a wage supplement to single mothers working at least half-time and the large drop in the buying power of the minimum wage. An analysis conducted by the Department of Health and Human Services shows that when the EITC expansion enacted in 1993 is phased in fully, the disposable income of a mother with two children who works half-time throughout the year at the minimum wage will be nearly \$3,000 lower than it was in 1972, after adjusting for inflation. (Disposable income includes wages, average AFDC benefits, food stamps, and the EITC, minus federal income and payroll taxes.)

The HHS analysis found similar results for single parents with two children who work 30 hours a week throughout the year at the minimum wage as well as for those working 40 hours a week. (See Table 1.) In both cases, the family's disposable income will be at least \$1,500 below 1972 levels, after adjusting for inflation, when the 1993 EITC expansions take full effect. In short, single parents working at the minimum wage will have less disposable income than they did in the early 1970s before the EITC was created.

The EITC expansions should be seen as part of a larger set of economic and policy developments. Economic forces pushing down wages for low-skilled work, combined with policy decisions in the minimum wage and AFDC areas, confronted policymakers with a need to increase the EITC substantially to avoid large reductions in the living standards of working poor and near-poor families with children.

Beneficial Aspects of the EITC

The 1986, 1990, and 1993 EITC expansions reflected decisions to help cushion the erosion of wages for low-paid work, while placing less emphasis on the minimum wage and AFDC as mechanisms to accomplish this goal. The expansions also reflected the desire of policymakers to make work more remunerative than welfare and bring families with a full-time working parent closer to the poverty line. Finally, these expansions reflected a recognition that with its faults, the EITC remains one of the soundest of the low-income transfer programs.

Table 1

Average Disposable Income For a Mother and Two Children From Wages, AFDC, Food Stamps, EIC, and Federal Taxes (in 1994 dollars)

Number of Hours Worked Per Week At Minimum Wage Throughout the Year

Year		20 Hours	30 Hours	40 Hours	
1972		\$13,827	\$14,976	\$16,057	٠
1980		11,772	13,199	14,145	
1990		10,082	10,735	11,804	
1995	(with EIC at fully phased-in 1996 levels)	10.925	12,505	14,462	

\$2 902

-21%

-\$2.471

-16%

-\$1.595

-13%

Source: Department of Health and Human Services

1972-1995

The EITC differs from most other means-tested transfer programs in two crucial respects. First, it is limited to those who work; those who do not work may not receive it. It thus helps to make work more remunerative than non-work rather than the other way around.

Second, unlike welfare benefits that decline as soon as income begin to rise — and can thereby discourage people from entering the labor force — the EITC increases as earnings rise up to \$8,900 (for a family with at least two children). It does not begin to decline until a family's income surpasses \$11,620 (in 1996) and then declines much more gradually as earnings rise than public assistance benefits do.

Moreover, the major EITC benefit — the EITC for families with children — is limited to parents that live with their children. Absent parents do not receive major EITC benefits.

The result is that the EITC rewards work and encourages those who are not working to enter the labor market. It also distinguishes the working poor from the non-working poor and custodial parents from absent parents. As Gary Burtless of the Brookings Institution has noted, the EITC probably has stronger beneficial effects and more modest adverse side-effects than most or all other programs to boost the incomes of low-income families.

Current EITC Issues

EITC Error Rates

In 1990, staff of the Senate Finance Committee, the House Ways and Means Committee, the Treasury, and IRS worked on a bipartisan basis to craft reforms to reduce the error rate. These reforms were enacted into law in that year's reconciliation bill. The GAO subsequently commented favorably on these changes, noting that they "should substantially reduce the number of erroneous EITC claims." But the changes enacted in 1990 addressed only part of the problem. Much more remained to be done. This was shown by a frequently cited, but sometimes misunderstood, IRS study of tax returns filed in January 1994.

The IRS study found that 26 percent of the EITC benefits claimed by filers whose returns were examined were claimed in error. This does not mean that the EITC loss rate was 26 percent. The IRS found that about 26 percent of the EITC benefits claimed on the tax returns it examined were claimed in error, not that 26 percent of the benefits actually paid were erroneous. The IRS detects some erroneous claims made on tax returns and avoids making overpayments on them. The actual overpayment rate in January 1994 would have been somewhat lower than 26 percent.

The 26 percent figure also may overstate the error rate in January 1994 for another reason. The 1,000 tax returns examined in the study were not representative of EITC returns filed in 1994. The returns examined in the study were limited to returns filed electronically during the first two weeks of the 1994 tax filing season. Electronic filing has been more susceptible to refund fraud than conventional tax filing, and some families that file in January do so before they have received all of their W-2 forms. In addition, some of the characteristics of the 1,000 filers examined in the

study do not match those of EITC filers overall. Many experts believe that EITC error and fraud are likely to have been higher among returns filed electronically in the first two weeks of the filing season than among EITC returns overall.

Recent Actions to Combat Error and Fraud

Since the time the study was conducted, the IRS has instituted a series of new procedures to address problems the January 1994 study identified. These changes appear to be lowering the error rates.

In 1994, the IRS checked little of the information on tax returns containing an EITC claim before sending out EITC checks. That has now changed sharply. In addition to verifying the Social Security numbers of all adults claiming the EITC, the IRS now also verifies the numbers of all children in EITC families — before sending EITC payments — to make sure the claims are valid and no child is claimed twice. (In 1994, the IRS did some checking of Social Security numbers, but the checking was less rigorous and less comprehensive. For example, in 1994 the IRS did not check to ensure that no child was claimed twice, and on many returns, the IRS did not verify children's Social Security numbers at all.) The IRS now also pulls EITC returns falling into any of several error-prone categories, sends these families a questionnaire, and requires families to provide additional documentation verifying their claims before payment is made.

Several million EITC returns have been delayed this year due to apparent discrepancies found in Social Security numbers or while EITC claims are verified. Nothing remotely on this scale has been done before.

In addition, during the first half of the 1994 tax filing season when the study was conducted, some filers could claim that they had applied for Social Security numbers for their children but had not yet received them. These filers could still receive the EITC. This procedure created an opportunity for abuse. It has since been fixed. Today, such EITC claims are denied.

Also, the GATT legislation enacted last fall includes a provision requiring Social Security numbers for infants who are claimed on a tax return. Until now, parents have not had to provide Social Security numbers for children under the age of one. This new provision, which takes effect in tax year 1995, will eliminate another potential problem area. To the extent that some problems involving Social Security numbers may remain, they would apparently be resolved by legislation the Treasury Department has submitted to Congress to strengthen the IRS' powers to deny questionable EITC claims.

Finally, the IRS has altered procedures relating to "refund anticipation loans." In the past, EITC applicants that used a commercial tax preparer were usually able to walk out the door with a check in the amount of their EITC benefit within a couple of days after they filed their tax return. Under the new procedures, checks are no longer provided on such a rapid basis, and use of refund anticipation loans apparently has fallen sharply. Those attempting to abuse the system who sought in the past to "take the money and run" can no longer do so.

Effects of These Actions

A new IRS study released last week indicates that if the procedures instituted this year had been in place in 1994, the January 1994 study would have found an error rate of less — and possibly significantly less — than 19 percent.

The IRS was able to determine the effect that some, but not all, of the new procedures (principally the procedures relating to Social Security numbers) would have had if they had been in effect in January 1994. The IRS found these procedures would have reduced the overclaim rate from 26 percent to 19 percent. The IRS was not able to measure the effect of the procedures instituted this year to delay those EITC claims that fall into an error-prone category while the IRS investigates and directs the filer to provide verification of certain aspects of the EITC claim. Had IRS analysts been able to factor in the effects those procedures would have had, the new procedures instituted this year would almost certainly have been found to have reduced the overclaim rate in the January 1994 sample below 19 percent.

Some long-overdue change in the processing of tax returns claiming the EITC is now occurring. Prior to 1991, the IRS did not obtain much of the basic information that establishes whether a family is eligible for the credit. Such information is now captured on Schedule EIC,

which was introduced in 1991. And until this year, the IRS made limited use — before making EITC payments — of the information it did receive. This is now changing.

The EITC and Work Incentives

Important issues are sometimes raised about the EITC and work incentives. Based on economic theory, it is generally assumed that the EITC encourages work among those working little or not at all. It is also assumed that the credit acts as a modest work disincentive for other families, primarily those whose income exceeds \$11,620 (in 1996) and whose EITC benefits are reduced as their earnings rise.

The issues relating to the credit's effects on work incentives are sometimes misunderstood. The effect of the EITC on the level of work performed by families whose incomes exceed \$11,620 is not clear. For the EITC to discourage these families from working more, the affected families would need to understand how the EITC is reduced as their earnings rise — that is, they would need to be cognizant of the EITC's effect on their "marginal tax rate." It is not clear how many families know this.

Furthermore, if the EITC does have some work disincentive effects on families whose EITC benefit falls as their earnings increase, these effects may not be adverse from society's standpoint. Both Robert Reischauer, then director of the Congressional Budget Office, and Henry Aaron, Director of Economic Studies at the Brookings Institution, made this point at an American Enterprise Institute symposium in 1990. Reischauer and Aaron noted that the families the EITC encourages to work more are likely to be quite different from the families the EITC may encourage to work less. The families encouraged to work more are heavily made up of single parents who work little if at all, precisely the group whose work effort we most want to boost. By contrast, the families whose EITC benefits decline as their earnings rise — families with incomes over \$11,620 — include large numbers of two-parent families. Reischauer and Aaron noted that a major part of the EITC's probable effect in inducing modestly less work among families in this income range is its effect in enabling a parent — usually the mother — in two-parent working families to work a little less so she can spend more time with her children.

Reischauer observed that this should not necessarily be regarded as an adverse outcome and that it may be desirable from society's standpoint for a parent in two-parent working families to be able to spend more time with her children. He cautioned that lumping increased work effort among single mothers who otherwise would work little or not at all with reduced work effort among married mothers in two-parent working families who wish to spend more time with their children can confuse rather than illuminate debates on the EITC's effects.

Reischauer and Aaron's point is supported by academic research and a GAO analysis. The GAO estimated that the percentage reduction in hours worked as a result of the EITC is four times greater among wives in two-parent families than among husbands in such families. In addition, the GAO's estimates showed little percentage change in work effort among single parents.²

In addition, the GAO study and most other previous studies examined the EITC's effects only on those already in the labor force. These studies did not examine whether the EITC draws non-workers into the labor force. New research by John Karl Scholz of the University of Wisconsin indicates the EITC has a strong positive effect in inducing single mothers outside the labor force to and begin working. The research of Scholz and his colleagues suggests that the increase in the number of hours worked by parents whom the 1993 EITC expansions will draw into the labor force will exceed the decrease in hours worked by those (principally wives in two-parent families) who may work somewhat less because of the expansion.³

Another recent piece of recent academic research, examining the EITC's effects on work effort among single mothers, produced similar results. It concluded that the EITC succeeds in increasing work among single mothers who previously have been out of the labor force and accomplishes this without diminishing work effort among single mothers whose EITC benefits decline as their earnings rise.⁴

In Congressional testimony before this Committee in 1993, the GAO succinctly summarized the EITC's effect on work. The GAO stated: "[The earned income tax credit] works. It offsets payroll taxes, increases progressivity of the tax system, and provides a positive work incentive to the lowest income group with only a slight disincentive to other recipients."

The EITC and Marriage Penalties

The issue of the EITC and marriage penalties is another complex area. The EITC penalizes marriage for some and rewards it for others. It does not represent an unambiguous marriage penalty.

In arguing that the EITC imposes a large marriage penalty, some critics cite a hypothetical case involving two potential marriage partners, each of whom is a custodial parent with at least two children living with them and each of whom earns about \$11,000. This hypothetical case does not provide a satisfactory basis for policymaking. It is the hypothetical case in which the marriage penalty is greatest and is exceedingly rare in the real world.

There are few cases in which two people who wish to marry each other are both custodial parents who each live with at least two children and each have incomes in this range. Most male single parents are *not* custodial parents, are not eligible for a significant EITC benefit, and do not lose EITC benefits if they marry.

Census data indicate that of all marriages that occurred in 1990, fewer than two-tenths of one percent involved a man with two or more children marrying a woman with two or more children. The likelihood of such a marriage in cases in which both parties are custodial parents and also have incomes around \$11,000 appears to be close to zero.

This does not mean the marriage penalty issue is not significant. But more typical examples should be considered when assessing the potential effects of the EITC on marital formation. The most common example in which the EITC can penalize marriage involves a single working mother with one child who is considering marrying a man who earns modest wages but does not live with a child or receive the EITC. The EITC such a couple would receive if they marry could be lower than the EITC the mother currently gets. If a single mother with one child who earns \$5,000 working part-time marries a male earning \$10,000, the EITC benefit in 1996 would drop \$82. If she marries a man earning \$15,000, the EITC would decline \$881. (These figures are for 1996, when the EITC changes enacted in 1993 are phased in fully.)

If the mother earning \$5,000 has nwo children, marrying a man earning \$15,000 would cause a smaller EITC loss — about \$200. And if such a mother marries a man earning \$10,000, the EITC benefit would increase about \$850. On the other hand, if the mother earns \$10,000 herself and has two children, the EITC benefit loss becomes larger. For example, if she marries a man earning \$10,000, the loss is \$1,760.

The EITC thus can penalize marriage. It also can reward marriage substantially. The EITC offers a sizeable marriage incentive to a single mother who has no earnings and receives AFDC. Since marriage is one of the principal routes out of welfare, it is particularly important to encourage marriage among this group.

In the absence of the EITC, a non-working mother on AFDC who contemplates marrying a man with low earnings risks losing a great deal. If she marries, she and her children will become ineligible for AFDC and also lose some of their food stamps. In addition, she likely will become ineligible for Medicaid. Depending on her children's ages and her husband's earnings, some or all of her children may lose Medicaid coverage as well. The marriage penalties embedded in the welfare system are strong.

The EITC helps to offset these losses and ease these penalties. By marrying, the couple will gain an EITC benefit of up to \$2,157 if they have one child and up to \$3,564 if they have two or more children (when the 1993 expansions phase in fully). This will partially — and in some states, wholly — make up for the mother's loss of AFDC benefits when she marries.

For poor single mothers with little or no earnings, the EITC thus significantly lessens the marriage penalties the welfare system creates. It can provide these women an incentive to marry and leave welfare. This point is sometimes overlooked when the EITC and its effects on marriage are discussed. It is not accurate to speak of the EITC as simply penalizing marriage. It penalizes it for some and rewards it for others, including the group for which there is the greatest concern for encouraging marriage, single mothers on welfare.

Proposals to Alter the EITC

Additional steps would be useful in reducing errors. In particular, legislation the Treasury Department has submitted to strengthen the IRS' ability to deny questionable EITC claims would

represent an important addition to IRS' error-fighting arsenal. In addition, the IRS is currently conducting a study of EITC errors in tax returns filed in 1995. These findings should lead to additional administrative actions to combat errors and may also suggest some additional legislative steps that might be taken.

I am concerned, however, that a number of EITC proposals now emerging in Congress are not compliance provisions designed to reduce error rates. Some emerging proposals would reduce EITC benefits largely through broad-scale benefit reductions, not through new procedures to improve the accuracy of EITC payments.

Some of these proposals would affect millions of honest families in which a parent works for low wages. These include proposals to repeal part or all of the 1993 EITC changes and a proposal to repeal the indexing of the EITC for inflation.

Repealing Part or All of the 1993 EITC Expansion

The budget resolution the Senate approved in May assumes partial repeal of the EITC expansions enacted in 1993. Those expansions substantially increased the EITC for families with two or more children and also established a small credit for very poor workers without children.

The 1993 provisions were designed to attain the bipartisan goal that families (or at least, families of up to four people) should not live in poverty if a parent works full time throughout the year. This goal was endorsed across the political spectrum in the years before 1993. Accordingly, the 1993 law set the EITC for a family with two or more children at the level that would bring a family of four with a full-time minimum wage worker to the poverty line if the family also received food stamps (and if the minimum wage kept pace with inflation, as President Clinton had earlier recommended).

The 1993 expansions also were designed to reduce the work penalties built into the welfare system and to make low-wage work more remunerative than public assistance. When families leave welfare for work, they lose cash welfare payments, some of their food stamps, and, ultimately, some or all of their family's Medicaid coverage. The increased EITC payments help to offset this loss and make the overall compensation package from working compare more favorably with continued reliance on public assistance.

The 1993 EITC expansions helped to promote work in another way as well. Payroll taxes consume 15.3 cents of each additional dollar a poor family earns while food stamp benefits consume 24 cents. For families with two or more children and low-wages, the EITC will fully offset these adverse effects, providing a 40-cent credit for each additional dollar earned when the 1993 expansions are in full effect.

The 1993 law also aided very poor workers without children. It created a small EITC that provides a maximum credit of a little more than \$300 — and an average credit of about \$170 — for poor workers between the ages of 25 and 64 who do not live with children and have incomes below about \$9,500 (in 1996).

A small EITC was extended to these workers partly because their federal tax burdens had escalated sharply since 1980 as a consequence of a series of regressive payroll and excise tax increases. A Congressional Budget Office analysis showed that between 1980 and 1983, the average federal tax burden of the poorest fifth of non-elderly households rose 38 percent. This dwarfed the increase in tax burdens borne by any other group of households in any income category. By 1993, the percentage of income that the poorest fifth of non-elderly households without children was paying in federal taxes was double the percentage of income paid by the poorest fifth of families with children and more than five times the percentage paid by the poorest fifth of elderly households.

The sharp increase in the tax burdens borne by these households occurred primarily because of a series of increases in Social Security, gasoline, and other excise taxes. For low-income families with children, these regressive tax increases were generally offset through EITC expansions. For poor workers without children, no offsetting actions were taken before 1993. Accordingly, the 1993 law established a modest EITC that offsets the payroll tax these workers pay on their first \$4.230 in income (in 1996) and phases out when income reaches \$9,500.

In addition to offsetting a portion of these tax increases, the EITC for poor workers without children also has the effect of nearly completing a piece of unfinished business from the $1986\,\mathrm{Tax}$

Reform Act. One of the Act's goals was to eliminate income tax burdens on workers below the poverty line so they were not taxed deeper into poverty. The 1986 Act accomplished this goal for all filing units except non-elderly single individuals. Prior to the extension of the EITC to these workers, a single worker began owing federal income tax when his or her income was about \$1,300 below the poverty line. The EITC has raised the income level at which these workers begin owing income tax close to, although not all the way to, the poverty line.

The Senate Budget Resolution

The EITC changes assumed in the Senate budget resolution would repeal the small EITC for workers without children. These changes also would cancel entirely the final phase of the EITC expansion for families with two or more children, scheduled to take effect in tax year 1996, and scale back the EITC benefit structure in place in tax year 1995.

Poor workers without children would face a substantial increase in their federal tax burdens; the payroll taxes they pay on their first \$4,230 of earnings would no longer be offset. In addition, their federal tax burdens would rise to higher levels than these burdens had reached before the 1993 law took effect, because these workers would be affected by the gasoline tax increase enacted in 1993. The Treasury Department estimates that 4.4 million workers would face an average tax increase of \$173 if the credit for workers without children is repealed.

Families with children also would be affected significantly. Eight million families with two or more children would lose a maximum of \$445 and an average of more than \$300. In addition, about two million families with one child would lose up to \$244 each. As a result of these changes, the number of families in which a parent working full-time at a low wage would fail to escape poverty would rise somewhat, while the extent to which work paid more than welfare would be lessened.

Few of the low-income workers who would be adversely affected by these changes would benefit from any of the tax cuts currently under consideration. CBO data show that because the proposed children's tax credit is not refundable, the one-third of the children in the country with the lowest incomes would not benefit from it. If a children's credit is enacted for families with incomes of up to \$250,000 while the EITC is scaled back, the effect will be to grant a children's credit to families at relatively high income levels while withdrawing part of a credit for families with children that are working at low wages.

The EITC and Inflation Adjustments

A proposal also has been advanced to end indexation of the EITC. Curiously, this proposal would undo a Reagan initiative. It was President Ronald Reagan who proposed in 1985 that the EITC be indexed.

The Reagan proposal was designed to fix a problem in the EITC benefit structure. If the EITC is not indexed, millions of working poor and near-poor families find that if their earnings simply keep pace with inflation, their EITC benefits decline each year while their payroll taxes climb. The result is the imposition of steadily increasing tax burdens on working families that have experienced no increase in purchasing power.

A family's EITC benefit begins to phase down when the family's income passes a certain income level. For every dollar that a family with two children earns above \$11,620 (in 1996), the EITC is reduced 21 cents. This \$11,620 income threshold is indexed for inflation. If indexation is repealed, a family with income at or above \$11,620 whose income rises at the rate of inflation will find its EITC falls even though the family's purchasing power has not increased.

Such a family also will owe more in payroll taxes. For each dollar its earnings rise, the family's payroll taxes will increase 7.65 cents while its EITC drops 21 cents.

The effects of failing to index the EITC would grow with each passing year. If a family's income simply kept pace with inflation and EITC indexing had ended, a family with two or more children and income of \$12,000 in 1996 would, five years later, receive an EITC \$460 smaller than the credit it had received in 1996. The family's EITC would be more than \$1,000 lower than it would have been had the EITC continued to be adjusted for inflation. And while its EITC was falling, the family's payroll tax would have climbed \$167.

In real terms, the purchasing power of such a family's EITC would decline by 27 percent in the five-year period. For some working families, the decline would be steeper. Families that earn

\$20,000 and whose wages simply keep pace with inflation would find that the purchasing power of their EITC would decline more than 50 percent over five years if indexation ended.

Ending indexation of the EITC would be unwise. It would result in substantial increases over time in federal tax burdens for large numbers of low-income working families that have experienced no increase in their standard-of-living. It also would make millions of working poor families with children poorer over time and turn a steadily increasing number of near-poor working families into poor families, by pushing them below the poverty line. The Treasury Department estimates that by 2000, nearly 18 million tax filers would be adversely affected by this proposal.

Ending the indexation of the EITC also would be inconsistent with the goals of "making work pay" and promoting work over welfare. If the EITC is not adjusted for inflation, the gain from working at a low-wage job rather than relying on welfare will erode as the real value of the EITC declines over time.

Finally, ending EITC indexation would be inconsistent with other Congressional action being taken this year. There is no discussion of ending the indexation of other features of the tax code such as the personal exemption, the standard deduction, or the tax brackets. If EITC indexation ends, families at higher income levels would continue to be shielded from the effects of inflation on their tax burdens while working poor and near-poor families faced substantial tax increases. Moreover, the House of Representatives has passed legislation to index capital gains tax benefits, the estate and gift tax, and depreciation deductions used primarily by large corporations. It is difficult to discern how ending EITC indexation fits in with these other policies unless the principle is that affluent investors and large companies need protection against the effects of inflation on their taxes but low-income working families do not.

Proposals such as repealing part of the 1993 EITC changes or ending EITC indexation have a common feature. They would leave low-income working families facing eroding wages for low-skilled work, a sharply lower minimum wage in real terms, and the near-elimination of cash welfare assistance for families working more than half-time with reduced help from the earned income credit. The policy instrument supported for years by many who oppose raising the minimum wage and advocate reducing public assistance programs would itself be scaled back or partially withdrawn.

The "Wealth Test"

Several other EITC proposals warrant comment. In April 1995, Congress passed legislation denying the EITC to families with more than \$2,350 in income from interest, dividends, rents and royalties. The Clinton Administration had proposed a similar provision, with a limit of \$2,500, adjusted for inflation.

Three issues have been raised concerning this provision. Should additional forms of income should count against it? Should the \$2,350 level should be lowered? Should the \$2,350 level be indexed?

Additional forms of income probably should count against this limit if this cannot be done without making the EITC too complex. (Increasing the complexity of the credit is a sure way to push error rates back up.) Some have proposed counting estate and trust income, net passive business income, and net capital gains income against this limit. This proposal appears sensible if it does not add too much complexity.

On the other hand, I would not recommend lowering the threshold from \$2,350 to \$1,000, as has also been suggested. A threshold that low would disqualify some poor and near-poor working families that are saving for legitimate reasons, such as to send a child to college, purchase a home, start a business, or meet a medical emergency (an increasing concern as the number of low-income working families that lack health insurance rises). Prudent policy would not force families saving to make an investment in their future to choose between losing their EITC and consuming enough of their savings to remain below the EITC limit.

A preferable approach would be to reduce the \$2,350 limit modestly to \$2,000 and index it for inflation. (Whatever the level at which the threshold is set, the level ought to be adjusted for inflation. Otherwise, the credit will ultimately be denied to families with a strong need for it as the limit erodes over time.) This would generate approximately the same level of savings over the next 10 years as the provision that Congress passed in April 1995, while insuring that as the years

pass, the limit does not squeeze out a steadily increasing number of low-income working families with a legitimate need for the credit.

Counting Social Security and Child Support Payments

Senators Roth and Nickles have proposed that Social Security, tax-exempt interest, non-taxable pension distributions, and child support be counted as part of adjusted gross income (AGI) for purposes of determining eligibility and benefit levels for the EITC. The argument for counting Social Security is that Social Security benefits represent income these families receive, and this income makes these families less needy. Among the arguments against this proposal are that counting Social Security benefits as part of AGI when determining EITC eligibility and benefit levels would effectively subject Social Security beneficiaries who are raising children to larger taxes on their Social Security benefits than some other Social Security beneficiaries with higher incomes. In addition, counting all of Social Security as part of adjusted gross income for EITC purposes could be problematic because a portion of Social Security benefits represents a return of payments that beneficiaries made from income on which they have already paid taxes.

While there are pros and cons to this proposal, it will be difficult to justify it if the provision enacted in 1993 that makes 85 percent of Social Security benefits taxable for more affluent beneficiaries is repealed. If that is done and Social Security also is counted as part of AGI for EITC purposes, the effect will be to reduce tax burdens on Social Security beneficiaries at high income levels while increasing tax burdens on Social Security beneficiaries at lower income levels.

Counting child support as part of AGI for EITC purposes would be ill-advised. This change, which would reduce the EITC for many divorced working mothers, would pose both administrative and tax equity problems. The Internal Revenue Service has no information on the child support payments that a custodial parent receives, and it lacks a reliable means of securing this information. Consequently, such a proposal would be difficult for the IRS to enforce and almost certainly would result in higher error rates. The General Accounting Office recently noted the difficulties of administering a requirement of this nature.

Counting child support in this manner also would cause double-counting of income. Noncustodial parents already pay income tax on the income from which child support payments are made. Counting child support payments as part of AGI and lowering the EITC as a result effectively taxes this income twice.

Finally, such a policy change could lead to a reduction in child support collections. Since some of the non-custodial parent's support payments would effectively be taxed away, some non-custodial parents would have a reduced incentive to make child support payments.

Conclusion

Steps have been taken in recent years to reduce EITC error rates. More needs to be done. Some other changes in the EITC also may warrant consideration.

But we should not lose sight of the EITC's strong virtues. The EITC is boosting the incomes of millions of poor and near-poor families with children that are working and staying off welfare. With the steady erosion of wages for low-paid work over the past 20 years and the likely continuation of this trend in the future, the EITC plays a critical role. It also provides an important underpinning for welfare reforms to move families from welfare to work and helps to offset regressive taxes that low-income workers face.

In addition, the EITC has helped change the federal income tax system from a system that pushes working poor families deeper into poverty to a system that helps lift them out. An analysis by the Department of Health and Human Services found that in 1984, the tax system pushed 1.8 million people living in families with children below the poverty line. When the recent EITC expansion is phased in fully, the tax system will lift more than two million such people out of poverty.

The EITC has been substantially tightened this year to reduce errors and attack fraud. Further improvements are needed. But deep reductions in the EITC benefits of honest low-income working families would not represent sound policy.

End Notes

- General Accounting Office, Earned Income Tux Credit: Design and Administration Could be Improved, September 1993, pp. 58-59.
- 2. General Accounting Office, September 1993.
- John Karl Scholz (University of Wisconsin, Madison), testimony before the Senate Governmental Affairs Committee, April 5, 1995; and Stacey Dickert, Scott Houser, and John Karl Scholz, "The Earned Income Tax Credit and Transfer Programs; A Study of Labor Market and Program Participation," November, 1994.
- Nada Eissa (University of California, Berkeley) and Jeffrey B. Liebman (Harvard University), "Labor Supply Response to the Earned Income Tax Credit," December, 1994.
- Most economists believe that employees effectively pay both the employer and the employee share of payroll
 taxes, with the employer's share of the tax being passed through to employees in the form of lower wages.

Chairman JOHNSON. Thank you very much for your testimony, Mr. Greenstein.

Next will be Mr. Steuerle.

STATEMENT OF C. EUGENE STEUERLE, PH.D., SENIOR FELLOW, URBAN INSTITUTE, WASHINGTON, DC

Mr. STEUERLE. Thank you, Madam Chairperson. It is an honor to work again with these Subcommittees on this issue. I, as Mr. Gibbons, have a bit of age on this issue. I worked on the issue as long ago as 1978 when we tried to simplify the EITC so that we could get it to more eligible people. In the tax reform effort in 1984–86, I introduced indexing into the Treasury proposals at that time as a means of increasing the EITC. I am honored again to work with you on this issue.

My own conclusions to date can be summarized as follows, first the EITC represents an important step in my view in society's attempt to find an alternative to welfare. Second the EITC can best be assessed against alternatives to help low-income households and workers, but not really as a stand alone provision. Third, as currently designed, I have serious questions whether the EITC can be fully enforced by the IRS. And finally, EITC reform can be better accomplished within broader reform of our tax and transfer structures.

I will try to speak very briefly on each of those points. The EITC was expanded substantially in the Tax Reform Act of 1986 and in the budget agreements of 1990 and 1993.

Interestingly, the Clinton administration likes to claim the EITC expansions as one of its major achievements. In fact, the largest expansions of the EITC occurred under Presidents Reagan and Bush, at least when measured in terms of total costs.

Over the years the EITC has been argued to fulfill several purposes. One is to provide assistance to low-income individuals; a second to provide work incentives; and third, more recently it has been contrasted favorably to increases in the minimum wage.

The EITC does not meet any of its goals perfectly. As a compromise, however, it often meets its combined goals better than other alternatives including a pure welfare system and mandates on employers such as minimum wage increases.

The history of the EITC makes it clear that as an incremental step toward a different design of our combined tax and transfer system what makes the EITC distinct and unique and different from the welfare systems is its requirement that at least some income be earned in order to receive the credit. In a sense the phase-in range for the credit is nothing more than a rough work test.

Does this EITC create distortions? Well, as an economist I would have to argue of course it does, as do all taxes and transfers. On net, is it a positive work incentive for the population as a whole? I find that highly unlikely especially when one takes into account the taxes being paid by the taxpayers who have to support the system.

This argument, however, I believe begs the question on the EITC. It is less clear that providing say, \$3,000 of earned income credit to someone who earns a modest income is any less of a work

disincentive than providing \$3,000 of pure welfare benefits to someone who does not work at all.

Moreover, among those who might be given the greatest additional incentives to work are those welfare recipients whose participation in the work force would integrate them more fully into the rest of society—a point just emphasized by Mr. Greenstein.

Unfortunately, as currently designed, I do have serious doubts that the EITC can be fully enforced by the IRS. As best as I can tell there have been three major sources of noncompliance with the EITC.

The first had to do with individuals claiming the EITC even when they had not provided adequate information to meet various support tests and similar eligibility criteria. A second source of noncompliance derived from excessive claims on number of children, a discussion you had quite extensively with the previous panel.

My impression is that the IRS and Treasury, along with recent and proposed Congressional reforms, are going a long way to deal with these two particular problems. A final problem, however, is more fundamental. Now that the EITC rate is substantially in excess of all Federal tax rates, including the Social Security tax, there is a powerful incentive for households not in the welfare system to overdeclare earnings even when there are none. This incentive is gradually creating what I call a new superterranean economy.

The IRS audits only a minor fraction of returns. Even if it audited everyone it would be very difficult to disprove whether self-employment income was real or fictional. Moreover, in some cases legal work creation becomes profitable, as when neighbors simply exchange babysitting and then claim the EITC.

It is unclear how far this problem has developed to date. Nonetheless, I believe that it is crucial that the problem be attacked sooner rather than later.

My final point is that the EITC reform can be better accomplished within broader reform of our tax and transfer structure. Reform of these systems as they apply to low-income individuals is almost never attempted on a comprehensive basis. As one consequence, the combined tax rate on AFDC recipients is still extraordinarily high, in excess of 70 percent at one times minimum wage; at two times minimum wage, and even at three times minimum wage.

More comprehensive reform would allow one to try to deal with these complex interactions—for instance, by trying to integrate together the child credit that is in the tax bills in Congress with the EITC. This issue was discussed with you by Congressman Petri, John Forman has also got some suggestions along these lines.

Barring this more comprehensive approach something still must be done about potential overdeclarations of income. Someone besides the taxpayer, in particular in the case of self-employment income, has to be involved in the monitoring of the declarations of income. For tax systems traditionally that has been the employer who reports income to the IRS and for welfare systems that has traditionally been local welfare agencies. In sum, the EITC is not a perfect program. It represents a compromise among many competing goals. Its current design may represent merely a step toward replacing welfare with a broader support system more oriented toward work. At a minimum, the EITC today must be reformed to avoid the creation of a larger super terranean economy where overdeclarations of earnings can generate excessive claims for the credit. Ideally reform would be considered along with other welfare and tax reforms including any child credits that might be considered by Congress at this time.

Thank you.

[The prepared statement and attachments follow:]

STATEMENT OF C. EUGENE STEUERLE, PH.D. SENIOR FELLOW, THE URBAN INSTITUTE, WASHINGTON, D.C.

Mr. Chairman and Members of the Committee

Among the many provisions being considered for reform this year is the earned income tax credit (EITC). In size and scope the EITC has become one of the most important elements of the nation's combined tax/transfer scheme applying to low-income individuals. A major reason for its expansion is that the EITC generally has obtained bipartisan support within the context of major tax and budget reforms. I myself introduced EITC indexing into the 1984 Treasury proposals leading up to tax reform in 1986. It is not surprising that after such a period of legislative expansion, we would begin a more in-depth examination of the credit. An important part of that examination relates to how well the credit fulfills its various goals and whether there are alternative or better ways of fulfilling the same objectives. My own conclusions can be summarized as the following:

- (1) As a society, we are engaged in a fundamental, but difficult, attempt to try to find alternatives to welfare. The EITC, as a device to try to make work more attractive than welfare, represents an important step in that direction.
- (2) All transfers and taxes distort some choices, and the EITC is no exception. The EITC can be best assessed against alternatives that attempt to help low-income households and workers, not as a stand-alone provision.
- (3) As currently designed, the EITC cannot be fully enforced by the IRS and, to deter abuse, must be supplemented by further restrictions or restructured.
- (4) EITC reform often can better be accomplished within broader reform of our tax and transfer structure.

Background

The growth of the EITC in recent years has been relatively swift; indeed, it has been perhaps the fastest growing of all federal budget items whose growth is due to recent legislative action. Table 1 traces some of that growth. As can be seen, the credit was expanded substantially in the Tax Reform Act of 1986 and the budget agreements of 1990 and 1993. Interestingly, the Clinton Administration likes to point to the EITC expansion as one of its major accomplishments, while some critics like to blame this Administration for any defects of the credit. Yet the largest expansions of the credit took place under Presidents Reagan and Bush -- at least when measured in terms of total cost.

Over the years, the EITC has been argued to fulfill several purposes. One is simply to provide assistance to low-income individuals. In this regard, it has achieved modest success, as can be seen in the antipoverty statistics of Table 2, although it pales in comparison with social insurance programs such as Social Security. Of course, the EITC is targeted to many low-income families whose income is in excess of the fairly low, official poverty levels.

A second purpose of the EITC is to provide an offset to Social Security taxes and, perhaps, other federal taxes. For most families today, the combined employer and employee Social Security tax rate is more important than the income tax rate. It is not hard to understand why: the Social Security tax rate is 15.3 percent on all earnings, while personal exemptions and standard deductions set tax-exempt amounts that insure that low-income individuals pay almost no income tax. For incomes in excess of tax-exempt amounts, the income tax rate for most taxpayers is 15 percent only on the excess amount.

The EITC expansions of 1990 and 1993, however, could not be justified as offsets to federal taxes. The rate of credit was scheduled to rise as high as 25 percent under the 1990 agreement and as high as 40 percent under the 1993 agreement (see Table 3). Since most individuals at low-income levels do not pay income tax, and the Social Security tax rate is 15.3 percent, the EITC pays out far more to many individuals than they pay in any form of federal tax.

While the 1990 and 1993 reforms mainly increased the rate of credit, they made some other changes as well, such as an expanded credit for families with more than one child and a reformed definition of eligibility that was based more upon the home in which a child resided and less upon the amount of monetary support provided. These reforms did not change fundamentally the structure of the EITC system, the income levels at which a maximum credit would be reached, and the levels at which no credit would be made available.

A final rationale for the credit was to provide work incentives. Here, the target was primarily individuals who were on or who might otherwise receive welfare. The connection to other types of

transfers -- in particular, Aid to Families With Dependent Children (AFDC) -- is made fairly obvious by the restriction of the credit primarily to families with children. This work incentive goal cannot really be separated from the broader transfer and antipoverty goals. That is, the EITC cannot be justified as work incentive alone, but only as an alternative to other mechanisms to try to make transfers to low-income individuals.

Although comparisons to AFDC have been made throughout the history of the credit, more recently it has also been contrasted favorably to increases in the minimum wage. Many economists believe that increasing the minimum wage reduces the jobs that would be made available to workers whose productivity is between an existing minimum wage and some, new, higher level. Analyses of minimum wage workers, moreover, show that many of them are in middle-income families: older workers with assets and pension income, and married couples where one spouse already works at much higher wages. Accordingly, the EITC has received much support as an alternative not only to welfare, but to minimum wage increases. In this regard, some health reform proposals, such as that of President Bush in 1992, included a health credit modeled largely after the EITC. Again, the argument was that such a credit would be superior to the implicit increase in the minimum wage that would follow a mandate on employers to buy health insurance.

In sum, the EITC does not meet any of its goals perfectly. As a compromise, however, it often meets the combined goals better than other alternatives, including a pure welfare system and mandates on employers.

From Welfare to a Work-Oriented Support System

Whether as a transfer to low-income individuals, an offset to other federal taxes, or a better subsidy than pure welfare or employer mandates, the history of the EITC makes it clear that it is an incremental step toward a different design of our combined tax/transfer system, as it applies to low-income individuals. Indeed, budget accounting uniquely counts separate portions of the EITC as both tax reduction and expenditure outlay -- demonstrating, once again, the need to view our tax and transfer systems in an integrated fashion.

What makes the EITC different from most welfare systems is its requirement that at least some income be earned in order to receive the credit. In a sense, the phase-in range for the credit is nothing more than a rough work test. Relative to welfare that pays the highest benefits to those with no earnings or income, the phase in of the credit has been designed to provide a maximum benefit at income levels approximating a full-time minimum wage job.

Recent years have witnessed several attempts to convert our welfare system more into a work-oriented support system. EITC expansions are only one example. Mandates that welfare recipients work and attempts to time-limit welfare are others. So also are targeted jobs credits and attempts to increase so-called disregard (minimum amounts of income that can be earned without loss of welfare benefits). None of these mechanisms, unfortunately, has solved many of the complex problems related to work and marriage penalties in transfer programs. Nonetheless, I would hate to see us reverse course and go back toward a purer welfare system. We seem to be in a transition stage, but without a clearcut map on how we will continue to proceed.

EITC Distortions and Effects on Work

Does the EITC create distortions? Of course it does, as do all elements of our tax and transfer system. On net, is it a positive work incentive for the population as a whole? Highly unlikely. All transfers are backed up by taxes -- first, by direct taxes to support the system, and, second, by indirect taxes when benefits are phased out as the income of beneficiaries increases. On net across all of society, the financing of transfer systems will tend to increase the potential taxes or losses from working more to a greater extent than the transfer might increase the potential gains to some individuals from working more. Of course, the eventual effect on labor force participation depends greatly on response rates to such incentives.

This argument, however, begs the question. If we as a society are committed to providing some minimal levels of well-being to individuals, especially children, then it is much less clear that providing, say, \$3,000 of EITC benefits to someone who earns a modest amount of income is any less of a work disincentive than providing \$3,000 of pure welfare benefits to someone who doesn't work at all. The EITC can best be assessed, therefore, against other alternatives that are designed, in part, to provide transfers to low-income individuals. Moreover, among those who might be given the greatest additional incentive to work are those welfare recipients whose participation in the workforce would integrate them more fully into the rest of society.

Compliance and the Superterranean Economy

Unfortunately, as currently designed, I doubt seriously that the EITC can be fully enforced by the IRS. The question of abuse, however, is a complex one that is easily confused because there have been several potential sources of abuse, some of which have been dealt with and some not.

Although the data from the IRS are incomplete, as best as I can tell, there have been three major sources of noncompliance with the EITC. The first had to do with individuals claiming the EITC even when they had not provided adequate support to meet support tests and similar eligibility criteria in the tax system. Some recent reforms went a long way to correcting this problem by changing some of the eligibility criteria and making the primary test the presence of the child within the home of the claimant. I should mention that the complex support tests and head of household tests in the current tax law remain a source of confusion and error even beyond the EITC.

The second source of noncompliance derived from excessive claims of children (and even fictional adults) within the household. Again, while the jury is partly out on the size of this problem that remains, my impression is that the IRS and Treasury have made considerable headway toward solving this problem, and that both Congress and the Administration will probably support some further procedures to insure the validity of social security numbers of taxpayers and their claimed children.

A final problem, however, is more fundamental. In normal tax and transfer systems, there is a tendency to underdeclare income to avoid taxes and the loss or phase out of benefits as incomes rise -- creating what is sometimes called the *subterranean* economy. Now that the EITC credit rate is substantially in excess of the Social Security tax rate -- that is, in excess of the only direct tax paid by many EITC recipients -- there is a powerful incentive for households not in the welfare system to overdeclare earnings even when there are none. This incentive is gradually creating a new *superterranean* economy.

Since the IRS audits only a very minor fraction of returns, usually much less than 1 percent of returns of low-income individuals, it is very difficult for it to monitor superterranean economy work that never takes place. Even if it audited everyone, it is very difficult to disprove that whether self-employment income was real or fictional. Moreover, in some cases, legal work creation becomes profitable, as when neighbors exchange babysitting for each other in order to benefit from the credit.

It is unclear how far this problem has developed to date. Welfare recipients, for instance, may still lose more than they gain from overreporting income. In this regard, let me note that the research on EITC noncompliance to date is inadequate and has been inadequately designed to get at the extent of some of these problems. Nonetheless, I believe that it is crucial that the problem be attacked sooner, rather than later. To deter further abuse, the EITC must be supplemented by further restrictions or partially restructured.

EITC Reform Within the Broader Tax and Transfer Structure

EITC reform often can better be accomplished within broader reform of our tax and transfer structure. The simple fact is that reform of these systems, as they apply to low-income individuals, is almost never attempted on a comprehensive basis. Most tax/transfer reforms, including of the EITC, have traditionally not been comprehensive, but, instead, have represented patches onto the existing system. As one consequence, as shown in Figure 1, the combined tax rate on AFDC recipients who take minimum wage jobs is still extraordinarily high — even if one assumes full implementation of EITC expansions adopted in 1993. And that rate remains above 70 percent at 1 1/2 times, 2 times, even 3 times minimum wage. What that means, more generally, is that work in the formal sector still doesn't pay much, making occasional work in the informal sector a better deal, despite recent EITC expansions.

More comprehensive reform would allow one to try to deal with complex interactions among programs, for instance, by trying to integrate together the child credit that is in tax bills in Congress with the EITC in ways that would reduce the very strong penalties on work and marriage in the current system. A more universal child credit, for instance, might be combined with an EITC phased in at a rate equivalent to the Social Security tax rate.

Barring this more comprehensive approach, something still must be done about potential overdeclarations of income. Someone beside the taxpayer has to be involved in the monitoring of declarations of income. For tax systems, traditionally that has been the employer who reports income to the IRS; for welfare systems, local welfare agencies have served as monitors.

Underreporting in the traditional tax system has always been a serious problem for independent contractors, sole proprietors, and some self-employed precisely because there is no one else keeping books on the same transactions. This same group is the one for whom potential overdeclaration of income would be hardest to audit.

An EITC with a subsidy rate of 15.3 percent might also be combined with a employer job credit that was required to be passed on to employees, but was refundable only to the extent of other taxes paid over by the employer to the IRS. <u>Thus</u>, total EITC might be limited by amount of tax payments made by a company on its behalf and as withholdings on employees. Or for those with minimal income tax liability, some form of earnings supplement might be made available through welfare agencies.

Again, I do not wish to imply that a more administrable system will not entail costs or a loss of benefits to some individuals. But the current system, in my view, is unsustainable because it has no basic way to audit or enforce compliance on the overreporting of earnings. If we keep building on this system of subsidizing jobs – a task that could well be taken up by the states with block grant money – we must develop better administrative mechanisms.

Conclusion

Relative to pure welfare systems and many types of employer mandates, the EITC represents an attempt to increase transfers to low-income individuals without some of the extraordinary work penalties of traditional welfare or some of unemployment and other costs imposed on low-income workers by minimum wage increases and other mandates imposed on employers.

The EITC is not a perfect program. It represents a compromise among many competing goals. Its current design may represent merely a step toward replacing welfare with a support system better oriented toward work. At a minimum, the EITC soon must be reformed to avoid creation of a superterranean economy where overdeclarations of earnings generate excessive claims for the credit. Ideally, its reform would be considered along with other welfare and tax reforms, including any child credits that might be provided.

Table 1

AMOUNT OF EARNED INCOME TAX CREDIT

Total Amount of Credit
(\$ billions)

Year	Pre-1986	1986 Reforms	1990 Retorms	1993 Reforms
1975	1.3	-	•	-
1980	2.0	-	-	-
1985	2.1	-	-	-
1990		7.5	-	-
1995		11.1	20.0	24.8
1998		12.9	23.0	30.4

SOURCES: Janet Holtzblatt, Janet McCubbin, & Robert Gillette, "Promoting Work Through the EITC," National Tax Journal XLVII, September 1994.

Table 2

ANTIPOVERTY EFFECTIVENESS OF CASH AND NEARCASH TRANSFERS: 1993

·	All Persons	Persons in Families with Children
otal Population (thousands)	259,588	144,754
lumber of poor individuals (thousands)		
Cash income before transfers	59,901	32,244
Plus social insurance	42,116	28,753
Plus means-tested cash transfers	38,963	26,726
Plus food and housing benefits	30,794	20,183
Less Federal taxes	33,442	22,183
Plus EITC	28,898	17,750
Number of individuals removed from		
poverty due to (thousands)		
Social insurance	17,785	3,491
Means-tested cash transfers	3,153	2,027
Food and housing benefits	8,170	6,543
Federal taxes	-2,648	-2,000
EITC	4,544	4,453
TOTAL	31,003	14,494

SOURCE: Sandra Clark and Sheila Zedlewski, The Urban Institute. Based on data from the March 1994 Current Population Survey. Assumes full implementation of EITC changes due by 1996, but population, poverty, and income levels in 1993.

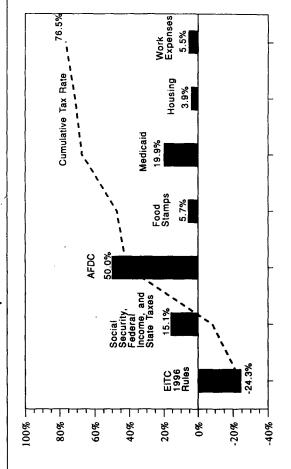
Table 3
EARNED INCOME TAX CREDITS PARAMETERS: PRE-1990 LAW, 1990 LAW, AND 1993 LAW
(All \$ amounts are in 1994 dollars)

PRE-1990 LAW

	Credit	Up To	Maximum	Phase-out	Phase Or	ıt Range
	Rate		Credit	Rate	Beginning At	Ending At
1990	14%	7,990	1,119	10.0%	12,580	23,760
1994 and after	14%	7,990	1,119	10.0%	12,580	23,760
		19	990 LAW			
	Credit	Up То	Maximum	Phase-out	Phase Ou	ıt Range
	Rate		Credit	Rate	Beginning At	Ending At
1991		-		-		
1 kid	16.7%	7.990	1,334	11.9%	12,580	23,760
2 kids	17.3%	7,990	1,382	12.4%	12,580	23,760
1992						
1 kid	17.6%	7,990	1,406	12.6%	12,580	23,760
2 kids	18.4%	7,990	1,470	13.1%	12,580	23,760
1993						
1 kid	18.5%	7,990	1478	13.2%	12,580	23,760
2 kids	19.5%	7,990	1558	13.9%	12,580	23,760
1994 and thereafter						
1 kid	23.0%	7,990	1838	16.4%	12,580	23,760
2 kids	25.0%	7,990	1998	17.9%	12,580	23,760
		19	993 LAW			
	Credit	Up То	Maximum	Phase-out	Phase Or	ıt Danga
	Rate	Op 10	Credit	Rate	Beginning At	Ending At
1994						
1 kid	26.3%	7,750	2,038	16.0%	11,000	23,755
2 kids	30.0%	8,400	2,520	17.6%	11,000	25,300
No children	7.7%	4,000	306	7.7%	5,000	9,000
1996 and thereafter						
1 kid	34.0%	6,000	2,040	16.0%	11,000	23,755
2 kids	40.0%	8,400	3,360	21.0%	11,000	27,000
No children	7.7%	4,000	306	7.7%	5.000	9,000

C. Eugene Steuerle and Gordon Mermin, THE URBAN INSTITUTE

Figure 1: Tax Rate on Minimum Wage Job By Source of Income Loss - Long-Term Sample: All AFDC Households



due to taxes and changes in benefits from the indicated programs. Tax credits for workers shown as Bars show proportion of income from a transition to full-time, minimum wage work that would be lost negative. Sample weighted by (household weight) (change in earnings). Source: Linda Giannarelli and C. Eugene Steuerle, THE URBAN INSTITUTE.

Chairman JOHNSON. Thank you very much. Mr. Scholz.

STATEMENT OF JOHN KARL SCHOLZ, PH.D., ASSOCIATE PROFESSOR, DEPARTMENT OF ECONOMICS, LA FOLLETTE INSTITUTE OF PUBLIC AFFAIRS; AND INSTITUTE FOR RESEARCH ON POVERTY, UNIVERSITY OF WISCONSIN-MADISON

Mr. SCHOLZ. Thank you, very much, Madam Chairman and Members of the Committee, for inviting me to testify on the effectiveness and design of the EITC. The EITC plays a central role in policy as it affects the working poor. Over the past 20 years there has been a striking change in the bottom of the Nation's earnings distribution, beginning in the seventies but accelerating over the eighties.

In 1973, the median male, without a high school diploma earned \$24,000. By 1989, the median worker with the same level of education earned nearly \$10,000 less in constant dollars. The trend is nearly dramatic for males with only a high school degree. The erosion of the Nation's labor market opportunities for people with low levels of education has placed enormous strains on the Nation's antipoverty program. Against this backdrop, the EITC has provided an important supplement to the earnings of low-skilled workers.

Many low-income families are not required to file a tax return even though by filing they may receive the EITC. If the credit is to be successful at meeting the objective of making work pay, families who are eligible for the credit should receive it. The best available evidence suggests that that indeed happens to a large extent; the participation rate of the EITC is around 80 to 86 percent.

The participation rate of the credit is strikingly high when compared to the AFDC and food stamp participation rates. The United Kingdom has an EITC-like program called the family credit administered through the transfer system and directed toward families with children. Official estimates place the participation rate of the family credit at only around 50 percent. Thus, both compared to the other inkind transfers in the United States and comparable work-related benefits in the United Kingdom, the EITC gets high marks for reaching those who are eligible for the benefit. This is the primary advantage of administering the EITC through the income tax system.

Nearly 50 percent of EITC payments by 1996 will go to taxpayers with incomes below the poverty line, and 36 percent of total EITC payments, more than \$6 billion, will directly reduce the poverty gap—the difference between total cash income and the poverty line. More than 75 percent of EITC benefits go to taxpayers with wages that would place them in the bottom 25 percent of all workers with children. That is below \$7.30 an hour. Thus, the EITC is well targeted

geted.

As people have mentioned, the EITC has different labor supply incentives depending on where the taxpayer's income is relative to the subsidy, flat and phaseout ranges of the credit. The subsidy range of the credit provides mixed incentives to work; the flat and phaseout ranges provide an unambiguous incentive to reduce hours of work. Most EITC recipients are in these ranges which raises the concern that the EITC may lead to a net reduction in the work ef-

fort of low-income workers. As Marv mentioned, this concern is borne out in studies on this issue.

The economic magnitude of these effects is small. The estimates that I deem most reliable suggests that the average reduction in hours worked, will be around 11 per year or one-half a percentage point of their total annual hours.

Moreover, to the extent that taxpayers are unaware of the effects of the credit on aftertax wages, both the positive effects of the credit and the subsidy range, and the negative effects of the credit on

taxpayers in the phaseout range are overstated.

In sum, the best available empirical evidence suggests that the EITC has a small but detrimental effect on the hours of workers. The credit exerts unambiguously positive labor market incentives on the decisions of whether or not to work.

The empirical work on this topic shows that the increase in net wages, provided by the EITC, positively affects labor market participation and negatively affects public assistance participation,

particularly among single parents.

This increase in participation is likely to offset or more than offset the reduction in hours worked. The evidence suggests that the EITC probably will, in aggregate, increase the hours worked by low-income people, but the positive effect is likely to be small. Thus, the EITC is not a magic bullet solution to the problems of low-wage labor markets.

At the same time, the modest positive labor market effects of the EITC should be contrasted to the detrimental effects on both labor market participation and hours of work associated with other

income transfer programs.

In the past years, a large number of ineligible taxpayers claimed the EITC according to unpublished data from the IRS Taxpayer Compliance Measurement Program. In 1988, over 30 percent of EITC claimants were ineligible; roughly one-third of the dollar claims were inappropriate.

The GAO testified in 1993 that the credit has been the source of more taxpayer mistakes than any other individual income tax

provision.

The future viability of the EITC depends on the ability of the IRS to reduce noncompliance. Doing so requires two distinct tasks. First, programs must be put in place to detect accurately and re-

port the degree of noncompliance and its causes.

I was pleased to read IRS Commissioner Richardson's testimony that the IRS will be doing a detailed EITC compliance study that is to be completed in 1995. Without credible numbers on the EITC noncompliance and evidence about the source of noncompliance, it is difficult to design policy to address the problem.

The IRS has now taken the second step needed to address noncompliance and that is giving greater scrutiny on verifiable items on tax returns. The IRS created an uproar this filing season due

to refund delays as it reviewed SSNs more closely.

Nevertheless, this effort together with matching employee and employer W-2 reports seem to be the best way of combatting the noncompliance that jeopardizes the program.

As long as the credit is based on items the IRS is able to verify there is nothing inherent in the credit that would lead to unusually high levels of noncompliance. Moreover, other areas of the Tax Code, for example, schedule C also have large amounts of noncompliance associated with them.

As a matter of sound policy, the costs of reducing noncompliance in every aspect of the Tax Code should be compared to its benefits, so the IRS uses taxpayer resources in as efficient a way as possible.

Just to conclude, the erosion of the bottom of the Nation's labor market imposes a pressing policy problem. The EITC is a sensible, well-targeted policy to address the problem. The credit is threatened by noncompliance.

I now sense that the IRS is taking strong steps to attack this problem. Their efforts should be given time to work. The reason for

this is that in other respects the credit is working well.

Most eligible taxpayers receive the credit; its labor market effects are probably in aggregate beneficial, and without a doubt, they are less pernicious than alternative ways of assisting the working poor; the credit is well targeted toward poor and near-poor families; and last, families receiving the EITC are working, an action that, in my opinion, should be encouraged.

Thank you.

[The prepared statement follows:]

Testimony before the Committee on Ways and Means, Subcommittees on Oversight and Human Resources

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Thursday, June 15, 1995

Mr Chairman and Members of the Committee:

Thank you for inviting me to testify on the effectiveness and design of the earned income tax credit (EITC). The EITC plays a central role in policy as it affects the working poor. Over its history, the EITC has received strong bipartisan support, as reflected by the fact that it was increased in 1986 and increased sharply in 1990 and 1993. The real value (in 1993 dollars) of the maximum EITC varied between \$739 and \$1,068 between 1975 – the year the EITC was adopted – and 1990. By 1996 the real value of the EITC will be roughly three times its 1990 level as a consequence of the 1990 and 1993 legislative changes.

The effectiveness of the EITC depends on (i) whether or not people eligible for the credit actually receive it, (ii) the labor market effects of the policy, and (iii) ensuring that those not eligible for the credit do not receive benefits. The first part of my testimony focusses on these aspects of policy design. The final section discusses a variety of EITC-related policy options.

Labor markets for low-skilled workers in the U.S. have not performed well over the last 20 years

To understand the role of the EITC, and in particular, its charmed existence over the past 20 years, a couple of facts about the labor market for low-skilled workers in the U.S. are useful. As Table 1 shows (next page), there has been a striking change in the bottom of the nation's earnings distribution, beginning in the 1970s, but accelerating over the 1980s. In 1973, the median male without a high school diploma earned \$24,079 (in 1989 dollars), by 1989 the median worker with the same level of education earned \$14,439. The trend is nearly as dramatic for males with only a high school degree. In 1973, the median male had an income of \$30,252, by 1989 the median male with a high school degree had an income of \$21,650. Average hourly earnings in private nonagricultural industries peaked in 1973 at \$8.55 per hours (in 1982 dollars) and, in 1994 were \$7.40 per hour. The erosion of labor market opportunities for people with low levels of education has placed enormous strain on the nation's antipoverty programs. Against this backdrop, the EITC has provided an important supplement to the earnings of low-skill workers.

The participation rate of the credit of the EITC is high

A family receives the EITC by filing a tax return, but many low-income families are not legally required to file returns. A married couple with two children, for example, was required to file a tax return in 1994 only if they had income above \$16,150, though with an income considerably less than

that, the couple would be entitled to an EITC of over \$3,000. If the EITC is to be successful at meeting the objective of "making work pay," families who are eligible for the credit should receive it.

Table 1: Median Income of Persons 25 and Over, by Educational Attainment and Gender, Selected years, 1989 Dollars

_	High S	School	College
Year	1-3 Years	4 Years	4+ Years
1967	\$22,858	\$26,894	\$39,186
1970	23,442	28,034	40,527
1973	24,079	30,252	41,065
1979	18,697	26,416	36,626
1983	15,138	21,932	35,188
1989	14,439	21,650	37,553

Source: Robert Haveman and John Karl Scholz, "Transfers, Taxes, and Welfare Reform," National Tax Journal, June, 1994, 417-434

It is surprisingly difficult to estimate the percentage of EITC-eligible taxpayers who receive the credit – the EITC participation rate. Household surveys generally collect the information needed to determine eligibility but do not provide information on EITC recipiency. Tax data are best for estimating EITC recipiency, but not all households file tax returns so they are unsuited for estimating EITC eligibility. In an earlier paper I used unique data that allowed me to determine EITC eligibility and EITC recipiency in the same data set: specifically, I use data from the 1990 Survey of Income and Program Participation (SIPP) matched by social security number to selected items from individual income tax returns. The paper describes, in great detail, the steps needed to calculate participation rates. Of the roughly 10 million taxpayers eligible for the credit in 1990, I estimate that between 75 to 90 percent received the credit. For reasons given in the paper, my preferred estimates place the participation rate at 80 to 86 percent.

The high participation (or take-up) rate of the credit is striking when compared to the AFDC participation rate of 62 to 72 percent and the food stamp participation rate of 54 to 66 percent.² The

¹For a more detailed discussion of participation rates, see John Karl Scholz, "The Earned Income Tax Credit: Participation, Compliance, and Anti-poverty Effectiveness," <u>National Tax Journal</u>, 47(1) (March, 1994): 59-81.

²These figured are calculated from the 1986 and 1987 panels of the Survey of Income and Program Participation (SIPP) by Rebecca M. Blank and Patricia Ruggles, in their paper "When Do Women Use AFDC and Food Stamps? The Dynamics of Eligibility Versus Participation," mimeo, Northwestern University and the Urban Institute, Washington, D.C., June, 1993.

United Kingdom has an EITC-like program called the Family Credit. It is administered through the transfer system and directed toward families with children. Official estimates place the participation rate of the Family Credit at around 50 percent. Thus, both compared to other in-kind transfers in the U.S. and comparable work-related benefits in the United Kingdom, the EITC gets high marks for reaching those who are eligible for the benefit.

The EITC is well targeted

Nearly 50 percent of EITC payments by 1996 will go to taxpayers with incomes below the poverty line and 36 percent of total EITC payment will directly reduce the "poverty gap" – the difference between total cash income and the poverty line. Because of the design of the credit, however, all benefits (other than those obtained fraudulently) go to taxpayers with incomes that are no more than 73 percent of the median family income in 1993. Put differently, the highest income an EITC-eligible taxpayer can have is \$27,000 while the median family income in 1993 was \$36,959. In this sense, the EITC is fairly well targeted to working poor or near-poor families.

There is little evidence that a significant number of EITC recipients are high-wage, part-time employees. Based on tabulations from the Survey of Income and Program Participation, I calculate that more than 75 percent of EITC benefits go to taxpayers with wages that would place them in the bottom 25 percent of all workers with children (below \$7.30 per hour). More than 95 percent of all EITC benefits are paid to workers with wages below the median of \$11.11 per hour. The EITC could be even more tightly targeted to lower income taxpayers by increasing the phase-out rate of the credit. Given the evidence on labor market incentives discussed below, doing so would probably not have particularly large deleterious labor market effects.

The EITC's labor market incentives vary with the income of the taxpayer

The EITC has different labor supply incentives depending on the taxpayer's income relative to the subsidy, flat, or phase-out range of the credit. The subsidy range of the credit increases the worker's marginal return to labor. For taxpayers with incomes in the subsidy range, the wage subsidy is thought to encourage work. At the same time, the income supplement provided by the EITC is thought to decrease recipients' labor supply because more money in hand means that they will choose to work less. The net effect is ambiguous. Households in the flat range of the credit receive the maximum EITC payment and no marginal subsidy for increased work, so these households have no marginal incentive to increase their hours of work, and the EITC supplement provides incentive to work less. In the phase-out range, the EITC is reduced as additional income is earned, which is akin to an additional tax on earnings. Thus the additional tax and the additional income both encourage workers to decrease their hours of work. For households that are not working, it is hoped that the wage subsidy provided by the EITC will encourage participation in the labor market.

The aggregate labor market effects of the credit depend on the distribution of taxpayers within the credit's ranges and the degree to which they respond to incentives. In my National Tax Journal paper I estimate that 77 percent of EITC recipients will have incomes that fall in the flat or phase-out range of the credit in 1996, which raises the concern that the EITC may lead to a net reduction in the labor supplied by low-income workers. The fact that an incentive exists, however, does not necessarily mean that people act on the incentive in an economically significant manner. In the following sections I describe work performed with Stacy Dickert and Scott Houser on the likely effect of the EITC on

labor market behavior.3

The EITC will have a small, negative effect on the hours worked by people already working

A large body of work in economics examines the effect of taxes and transfers on the hours worked by those in the labor market. Dickert, Houser and I survey this literature and use the empirical results from these studies to simulate the effects of the OBRA93 EITC expansions from 1993 to 1996.

Table 2 (next page), which is drawn from our paper, shows the effect of the 1993 EITC expansion, using 3 sets of labor supply estimates from studies that explicitly model the tax and transfer system. Between the estimates labelled "MaCurdy, Green, and Paarsch" on the low end, and "Hausman" on the high end, the estimates appear to span the range of estimates found in the literature. As expected, we find that the EITC will reduce hours for every group except those in the subsidy range of the credit. Studies of labor supply find that secondary earners are more responsive to changes in taxes and wages than are primary earners. Accordingly, our estimated labor supply responses are larger for secondary-earners in two-parent families than they are for primary earners or single-parent families

Our reading of the literature suggests Triest's estimates most closely reflect consensus estimates from various branches of the literature. Triest's estimates imply that taxpayers in the subsidy range of the credit will increase hours by roughly 38 hours per year, while taxpayers in the flat and phaseout range will reduce hours by 3 and 21 hours per year, respectively. When aggregated, EITC recipients are estimated to reduce hours by an average of 11 per year. Hausman's estimates are roughly 8 times as large, while the MaCurdy et al. estimates show virtually no response. Our estimates are consistent with, but update earlier estimates from a 1993 study by the General Accounting Office.

While the credit, in aggregate, is likely to reduce the hours worked by workers, the economic significance of these effects is small. Moreover, to the extent that taxpayers are unaware of the effects of the credit on after-tax wages, both the positive effects of the credit in the subsidy range, and the negative effects of the credit on taxpayers in the phase-out range, is overstated. Thus, the best available empirical evidence suggests that the EITC has a small, but detrimental, effect on the hours of workers.

The EITC will have a small, positive effect on labor market participation that probably is sufficient to make the aggregate effect of the EITC on hours of work positive

What's missing from the literature and our calculations from Table 2 are estimates of the EITC's effect on labor market participation. The credit has unambiguously positive labor market incentives on the decision of whether or not to work. Few papers provide guidance for thinking about the size of the effects of the EITC on labor market participation. This is somewhat surprising, as there is widespread agreement among economists that the strongest empirical labor market effects of wages and nonlabor income are on participation, rather than hours of work.

³The following discussion of the tax treatment of low-income households and the effects of the EITC on labor market participation and hours of work is described in more detail in Stacy Dickert, Scott Houser, and John Karl Scholz, "The Earned Income Tax Credit and Transfer Programs: A Study of Labor Market and Program Participation," <u>Tax Policy and the Economy</u>, James M. Poterba (ed.), National Bureau of Economic Research and the MIT Press, 1995, volume 9, pages 1-50.

Table 2: Simulated Labor Supply Responses to Changes in EITC Law from 1993 to 1996

Estimated Percent Change in Annual Hours Worked

Kinked budget set simulations²

	MaCurdy et al.	Triest	Hausman
All Recipients (160)	-0.09	-0.54	-4.04
By credit range			
Subsidy (80)	1.88	3.92	13.46
Flat (140)	~0.09	-0.19	-1.79
. Phaseout (160)	-0.53	-1.11	-4.73
By marital status		•	
Husbands (180)	0.00	-0.34	-3.17
Wives (140)	-1.47	-3.03	-11.36
Single female heads (160)	-0.53	-1.11	-4.02
Single male heads (160)	0.00	-0.18	-1.56
By sex			
Male (180)	0.00	-0.34	-3.15
Female (160)	-0.57	-1.17	-4.33

Note: See Dickert, Houser, and Scholz (1995) (the complete citation is in footnote 3) for further detail. Median monthly hours are in parentheses.

We identify the effects of the EITC on labor market participation by making use of the striking variation across states in the after-tax return to work. The typical low-income family in Texas, for example, faces relatively low cumulative tax rates — this calculation reflects both explicit tax rates from the federal income and payroll taxes, and implicit tax rates from benefit-reduction rules of food stamps and AFDC. Low tax rates are primarily a consequence of the low levels of AFDC benefits available to families in Texas. A household in similar circumstances in New York faces considerably higher rates, primarily because of the higher level of AFDC benefits. We find, for example, that average tax rates can exceed 85 percent for New York families receiving AFDC that enter the labor market and work anywhere from 8 to 35 hours per week. This implies that this family, when making labor market over a broad range of hours. If tax rates affect labor market participation, we expect labor market

⁴We characterize this variation using a detailed, microsimulation model we have developed that uses monthly data for the 1990 calendar year drawn from the Survey of Income and Program Participation (SIPP). The model is coded in the computer language C, runs on a personal computer, and contains detailed modules for SSI, AFDC, food stamps, the federal income tax, state income taxes, and payroll taxes. See Dickert, Houser, and Scholz (1995) for further details.

participation to be higher in low-benefit states than in high-benefit states, holding other observable characteristics constant.

Our study shows that net wages positively and significantly affect labor market participation and negatively affect transfer program participation, particularly for single parents. Moreover, this result is not an artifact of our particular empirical specification, but clearly emerges in the underlying data even when we do not control statistically for other factors.

The empirical evidence on the effects of the OBRA93 EITC expansion on labor market behavior is summarized in Table 3 (next page). We model the effect the EITC increase on net-of-tax wages, and calculate the implied change in the probability that individuals work. At the mean, the EITC increases the net wage of single-parent families by 15 percent. This leads to a 6.2 percent increase in their probability of working. If each new labor market entrant works an average of 20 hours per week for 20 weeks a year, the hours of single parent families would increase by roughly 72 million hours per year. Similar calculations show that the annual hours of primary earners in two-parent families would increase by roughly 12 million hours.

The EITC will probably discourage labor force participation of secondary workers in two-parent families, as entering the labor market is likely to place the family's income in the flat or phase-out range of the credit. Specifically, on average we calculate that the after-tax return to work for secondary earners will fall by nearly 5 percent as a consequence of OBRA93. We expect that to decrease labor market participation of secondary earners, leading to a reduction of roughly 10 million hours when using the same assumptions as above. Thus, we estimate that the aggregate increase in hours generated by increased labor force participation would be roughly 74 million hours.

The increased hours resulting from higher rates of labor force participation can be compared to the reduction in hours caused by the credit shown in Table 2. We use Triest's (1990) labor supply parameters for the simulation. We estimate that the annual hours of work for single-parent families in our sample will fall by 26.4 million hours, for primary earners they will fall by 13.6 million hours, and for secondary earners they will fall by 14.5 million, leading to an aggregate reduction of 54.5 million hours.

Taken together, the simulations suggest that the aggregate reduction in hours supplied by working households, 54.5 million, would be more than fully offset if new labor force participants work an average of 20 hours per week, 20 weeks per year. If either hours, or weeks worked are lower the offset will be smaller, while if new labor market entrants work more than 400 hours a year, the aggregate effect will be a larger positive number. The important point, however, is that one cannot forget about the participation margin when thinking about the labor market effects of the EITC.

Our evidence, like other papers before us, show that labor market participation appears to be sensitive to changes in wages and taxes. Hence, a policy like the OBRA93 EITC expansions that substantially increases the after-tax return to working for those not in the labor market are likely to elicit greater labor market participation. This increase in participation is likely to offset (or more than offset) the reduction in hours among those who work. The modest positive labor market effects of the EITC should be contrasted to the detrimental effects on both labor market participation and hours of work associated with other income transfer programs.

Table 3: Labor Market and Transfer Program Effects of the OBRA93 EITC Expansion, 1993 to 1996

Labor Market Eff	lects					
	New Labor For	ce Participants	Families in the Labor Market			
	Percent Change in Net Wage	Annual Hours Change Due to Labor Force Participation (million)	Annual Hours Reductions of Workers (million) ²	Average Annual Reduction in Hours		
Single Parents	15.0	72.8	26.4	10.1		
Primary Wage Earners	19.6	12.1	13.6	7.7		
Secondary Wage Earners	-5.0	-10.4	14.5	30.3		
Total		74.4	54.5	11.2		
Transfer Program	Participation Effects	<u> </u>				
	Number Leaving Program	Mean Annual Benefit	Mean EITC Payment			
Single-Parent Families	398,384	\$6,844	\$2,040			
Two-Parent Families	117,757	\$4,702	\$2,842			

Source: Dickert, Houser, and Scholz (1995).

EITC noncompliance has been too high, but sensible steps are now being taken to address the problem

In past years a large number of ineligible taxpayers claimed the EITC, according to unpublished data from the IRS's Taxpayer Compliance Measurement Program (TCMP). In 1988 10.4 million taxpayers claimed the EITC, whereas the TCMP for that year estimates that only 7.1 million were entitled to the credit, indicating that over 30 percent of EITC claimants were ineligible. Of the \$5.6 billion in EITC claims, the 1988 TCMP estimates that nearly \$2 billion (33.6 percent) were claimed inappropriately. A General Accounting Office official testified in 1993 that "the credit has been the

The estimation of the change in hours from new labor force participation assumes that, on average, these persons work 20 hours per week for 20 weeks per year.

²We use the estimated net wage and virtual income elasticities from Triest (1990).

source of more taxpayer mistakes than any other individual income tax provision."

Noncompliance takes many forms, though one of the frustrations with thinking about this topic is in assessing the relative importance of different circumstances. Parents that are separated (or even living together) may file separate returns and both claim the same child as a dependent. Taxpayers may make up children. Taxpayers may misreport earnings or AGI. Some of these cases may not reflect the intent to commit fraud, others clearly do.

EITC rules were changed in 1990 and a 2-page schedule was added to the tax forms because of the widespread perception of compliance problems, but there is little publicly-available evidence that the 1990 changes significantly reduced noncompliance. The IRS did a special study during last year's filing season, examining returns filed electronically during the first two weeks of the filing season, and found that roughly 26 percent of EITC claims were too high. Because of the nature of the sample that was drawn, it is unlikely that this sample was representative of the universe of filers, but the limited available evidence indicates that noncompliance is still a major problem.

The future viability of the EITC depends on the IRS being able to reduce EITC noncompliance. Doing so requires two distinct tasks. First, programs must be put in place to detect accurately and report the degree of noncompliance and its causes. Current policy is being debated in an environment where solid evidence on the magnitude of compliance problems is scanty. I was pleased to see that IRS Commissioner Margaret Richardson testified to the Senate Finance Committee last week that a detailed EITC compliance study is going to be completed in 1995.

The Internal Revenue Service has, perhaps belatedly, taken the second step needed to address noncompliance. This involves giving greater scrutiny to verifiable items on tax returns. The IRS created an uproar this past filing season due to refund delays as they give social security numbers greater scrutiny. Nevertheless, this and matching employee and employer W-2 reports, seem to be the best ways of combatting the noncompliance that jeopardizes the program. As long as the credit is based on items the IRS is, in principle, able to verify, there is nothing inherent in the credit that would lead to unusually high levels of noncompliance. Moreover, other areas of the tax code, for example, Schedule C also have large amounts of noncompliance associated with them. As a matter of sound policy, the costs of reducing noncompliance in every aspect of the tax code should be compared to its benefits, so the IRS uses taxpayer resources in as efficient a way as possible.

Even if the IRS is able to perfectly verify social security numbers and wage and salary income, future compliance problems may arise with self-employment income. Between 1975 and 1990 the subsidy rate of the EITC was roughly the same as the combined employee and employer share of the payroll tax. In this period, as long as the payroll tax and EITC subsidy are about the same, taxpayers will not overstate self-employment income in order to increase their EITC. Doing so would increase the taxpayer's EITC but would obligate the taxpayer to pay social security taxes on the self-employment income, eliminating any advantage to falsely reporting income.

With the sharp increase in the EITC, there are now stronger incentives to manipulate income. It is, of course, not yet clear how people will respond to these incentives, as there is no comparable situation in the tax code. My guess is that over time taxpayers or paid tax preparers will begin to take advantage of the incentive to overstate income in the subsidy range of the credit. The IRS will surely monitor closely the amount of income reported by low-income taxpayers that occurs in forms not subject to information-matching procedures (i.e., income from self-employment). An increase in the proportion of income occurring in these forms will be an early signal that a problem may be

developing.

A solution to the potential problems associated with self-employment income would be to restrict the expanded EITC to income reported on W-2s (and only allow an EITC equivalent to the employer and employee share of payroll taxes for other sources of income), though that would create an inequity between low-income wage earners and self-employed households.

Pending EITC proposals may not improve the tax system or the well-being of EITC recipients

In the past months various legislative proposals have arisen that would alter aspects of the EITC. The proposals include adding selected monetary payments to the income base in determining EITC benefits, repeal of indexation for the EITC, and limiting the EITC based on assets.

A current problem with the EITC is that several unverifiable sources of income are currently included in the EITC income base. These include housing allowances or the rental value of a parsonage for the clergy, excludable employer-provided dependent care benefits, voluntary salary reduction amounts (e.g., deductions to 401(k) plans), and anything else of value (money, goods, or services) received from someone for services performed even if it is not taxable (IRS Publication 596). With perfect compliance the inclusion of these items in the EITC income base may enhance the targeting of the credit, but reporting these income items is essentially voluntary. Given the difficulty of enforcing these provisions, I would support a proposal to restrict EITC eligibility and benefits to verifiable items. Adding new income items to the EITC income base that the IRS cannot verify, such as child support payments, non-taxable pension income, and tax-exempt interest would make the EITC even more difficult to administer, and would be a step in the wrong direction.

An important achievement of tax reforms in the 1980s is that most aspects of the tax system are now indexed to inflation. Unlike prior decades, ordinary taxpayers no longer see increasing tax burdens attributed solely to nominal, but not real, increases in income. It would be a very unfortunate change in policy if EITC indexation were eliminated. Working poor taxpayers would see an erosion of the real value of the EITC caused by the vagaries of inflation. If it is the intention of Congress to reduce the real value of the EITC or increase taxes in other ways, it should be done explicitly, rather than by repealing indexing.

Lastly, Administration and Congressional proposals would deny the EITC to taxpayers with assets (based on dividend, interest, and tax-exempt bond income) above some threshold. This proposal would be relatively straightforward to administer, and consequently could, in an effective manner, enhance the targeting of the EITC. I would not oppose such a proposal, though two things should be kept in mind when debating it. First, it will be relatively easy to manipulate portfolios so as to avoid the asset income thresholds without altering the value of the portfolio. Hence, the asset test will in all likelihood exclude fewer families than expected. Second, it may be counterproductive to implement a very restrictive asset test (such as those with a \$1,000 threshold). While asset tests of any kind enhance targeting in a static sense, they also can make it nearly impossible for recipients to legally accumulate the assets necessary to take a wide range of choices leading to independence – helping a child attend college, acquiring additional training, or moving away from a dangerous neighborhood.⁵

⁵For example, a family receiving food stamps cannot have financial assets exceeding \$2,000 (\$3,000 if the family unit has a member older than 59), and cannot own assets and a car whose combined market value exceeds \$6,500. A family receiving AFDC cannot have more than \$1,000 of financial assets. In a

As with high implicit tax rates on labor earnings, asset tests distort the economic decisions of low-income households and hence reduce the efficiency of antipoverty policy.

Conclusions

Over the past 20 years the EITC has been a favored policy tool for assisting low-income families with children. Between 1975 and 1990 the EITC remained roughly constant in real terms. By 1996 the real value of the EITC will nearly triple from its 1990 level. No other major program directed toward low-income families has grown at a comparable rate in recent years.

The effectiveness of the EITC will depend, in part, on its effect on labor market behavior. Most workers that will receive the credit have incomes that place them in the flat or phaseout range of the credit, where the credit provides an unambiguous incentive for people to work fewer hours. Using recent estimates from the empirical literature on taxes and labor supply, we find that the change in incentives caused by the 1993 expansion of the credit are expected to lead to a reduction in hours of work by those already in the labor market. Our central estimate predicts an overall reduction of roughly 54 million hours a year for families in our sample.

One of the attractions of the EITC is that it provides an unambiguously positive incentive to people not working to get a job. We find, both in descriptive tabulations and empirical models, that the after-tax wage has an economically and statistically positive effect on labor market participation and negative effect on transfer program participation. Thus, when fully phased in, the 1993 EITC expansion will increase labor force participation. Our preferred estimates suggest the magnitude of the participation effect will be large enough to offset the decrease in hours worked by workers.

While economists are predisposed to concentrate on the labor market responses to the EITC, the credit gets mixed reviews on two additional, important, policy dimensions. The participation rate – the fraction of eligible taxpayers that actually receive the credit – is quite high. The credit is reaching its intended beneficiaries. At the same time, many that are not eligible for the credit receive it. With the recent expansion of the EITC, the amount of overpayment could reach billions of dollars annually, an amount that, if it persists, will surely cause the credit to be scaled back, if not repealed altogether. I am hopeful that recent IRS attention to this problem will reduce the error rate and the credit will remain in place. My support for the credit results from the fact that (i) a high fraction of eligible taxpayers receive the credit, (ii) its labor market effects are probably, in aggregate, beneficial, and without a doubt, they are less pernicious than alternative ways of assisting the working poor, (iii) the credit is well-targeted toward poor and near-poor families, and (iv) families receiving the EITC are working, that is, they are "doing the right thing." Given the performance of labor markets for low-skill workers over the last 20 years in the U.S., it sound social policy to try to supplement the earnings of working poor families.

well publicized case, Cecelia Mercado was ordered by the Connecticut Supreme Court to repay \$9.342.75 in AFDC payments because her daughter, without her knowledge, had taken a part-time job and, in a year and a half, had saved almost \$5,000 toward attending college. To become recertified to receive AFDC, the daughter and her brother (who had saved nearly \$1,000) had to spend their saving until the household's assets fell below the \$1,000 asset limit (William Raspberry, Atlanta Journal and Constitution, \$/21/92, p. A10).

Chairman JOHNSON. Thank you, Dr. Scholz.

Professor Forman, we are going to hear your testimony, recognizing that the time is roughly 5 minutes and then we will recess for a few minutes to go and vote and come back.

Professor Forman.

STATEMENT OF JONATHAN BARRY FORMAN, PROFESSOR, COLLEGE OF LAW, UNIVERSITY OF OKLAHOMA, NORMAN, OKLAHOMA

Mr. FORMAN. Thank you, Madam Chairman.

Today the Federal tax system stands at an important crossroads and how this Committee next amends the EITC can change the future of tax policy for years to come. On the one hand, our Federal tax system could require more and more people to file complicated tax returns. On the other hand, we could move in a direction which minimizes the number of people who must even file tax returns.

I believe that the EITC should be restructured in a way that reduces the number of people who need to file tax returns while, at the same time, guaranteeing benefits for low-income workers.

My point is this, because millions of Americans must file tax returns to their earned income credits, there are millions of opportunities for them to make mistakes on their returns or for them to file fraudulent returns.

If it were up to me, I would do three things. First, I would move to a return-free filing system. Second, I would replace a portion of the EITC with an across-the-board \$5,000 per worker Social Security tax exemption. Third, I would replace the rest of the EITC with a \$1,000 per-child tax credit, along the lines of Congressman Petri's proposal or The National Commission on Children's proposal several years ago.

First, we should move to a return-free filing system in which the IRS prepares returns for most wage earners. Using information reports from employers and other income sources, the IRS could prepare tax returns for most 1040-EZ filers, most 1040-A filers and

a few 1040 filers, more than 55 million taxpayers in all.

Those Americans would no longer have to gather information, become familiar with tax laws or prepare and file returns. Nor, would they have to pay private preparers \$20 per return just for return preparation and additional fees for electronic filing and refund anticipation loans. In addition, under a return-free filing system, the burdens on the IRS would be reduced.

Second, Congress should replace a portion of the EITC with a \$5,000 per worker exemption from Social Security taxes. After all, much of the complexity in this area results from collecting Social Security taxes from every worker and then using the EITC to refund those taxes to low-income workers. Would it not be simpler if the Federal tax system did not collect those Social Security taxes in the first place?

With the Social Security tax exemption, at least 10 million tax returns could be eliminated immediately and IRS resources would be freed for other productive work. This is according to the Joint

Committee on Taxation.

Also, unlike, the EITC, which most workers collect around April 15 of the year following their work, a Social Security tax exemption

would result in extra money every paycheck. That would be a powerful work incentive. Unlike the EITC, a Social Security tax exemp-

tion would reach all 100 percent of low-income workers.

Finally, Congress should replace the rest of the EITC with a \$1,000-per-child refundable tax credit, along the lines of the credit proposed by the National Commission of Children in 1991. The credit would be available for all children through the age of 18. It would be refundable and indexed for inflation. Payment of the credit could come in the form of reduced withholding or a tax refund paid annually or perhaps quarterly. Your Committee might start by making the \$500-per-child tax credit in the House-passed tax bill refundable.

Unlike the current EITC, a refundable child tax credit would not create marriage penalties. That is because the credit amount would not depend on marital status or family income. Nor would a refundable child tax credit result in the kind of work disincentives that we see in the phaseout range of the EITC. Because the credit would be available to all families with children, regardless of income, it would not have to be phased out at all.

To summarize, by moving to a return-free filing system, and replacing the EITC with a \$5,000-per-worker exemption and a \$1,000-per-child refundable tax credit, Congress could guarantee benefits to low-income workers and free millions of Americans from

having to file returns.

Before concluding, however, let me mention two other possible alternatives to the current EITC. One alternative would be to combine the credit with other welfare programs, like food stamps and Aid to Families with Dependent Children. After all, having multiple Federal welfare programs has resulted in complexity, inequity, and high administrative costs.

Ideally it would make sense to combine the EITC and the other Federal welfare programs into a single comprehensive program that could be administered by a single agency. As this Committee well knows, both the IRS and the Social Security Administration do a great job of writing checks, so either agency could handle this

assignment.

Or the revenues now used for the EITC could be bundled together with the appropriations for other welfare programs and revenue shared out to the State welfare agencies.

In any event, the administrative savings that would result from combining the EITC with other welfare programs could be passed on to beneficiaries in the form of higher benefits.

The final alternative to the current EITC would be to replace it

with a tax credit for the employers of low-wage workers.

According to standard economic analysis the benefits of an employer tax credit would pass through to low-wage workers in the form of relatively higher wages. Consequently an employer tax credit could end up helping the very same people that we are trying to help with the EITC. Yet, an employer tax credit would be significantly easier to administer than the current EITC if only because there are far fewer employers than low-income workers.

Thank you, again, for this opportunity to testify.

[The prepared statement follows:]

TESTIMONY OF PROFESSOR JONATHAN BARRY FORMAN UNIVERSITY OF OKLAHOMA COLLEGE OF LAW BEFORE THE

SUBCOMMITTEES ON OVERSIGHT AND HUMAN RESOURCES HOUSE COMMITTEE ON WAYS AND MEANS EARNED INCOME TAX CREDIT JUNE 15. 1995

HOW TO REDUCE THE COMPLIANCE BURDEN OF THE EARNED INCOME CREDIT ON LOW-INCOME WORKERS AND ON THE INTERNAL REVENUE SERVICE

Madam Chairman, Mr. Chairman, and Members of the Subcommittees on Oversight and Human Resources:

Thank you for inviting me to testify before you today about the Earned Income Tax Credit.

My name is Jon Forman, and I am a Professor of Law at the University of Oklahoma. Although I am a tax lawyer by trade, I also hold Master's degrees in psychology and economics, and prior to entering full-time teaching, it was my privilege to work in all three branches of the federal government, most recently as Tax Counsel to Senator Daniel Patrick Moynihan (D-N.Y.). For the past ten years, I have been teaching courses about both tax law and welfare law, and I have written dozens of articles about the relationship between the tax and welfare systems./1

The purpose of my testimony today is to suggest ways to reduce the compliance burden of the earned income credit on low-income workers and on the Internal Revenue Service (IRS). Basically, I believe that there are ways to restructure the earned income credit that would guarantee benefits for low-income workers and also free millions of Americans from having to file income tax returns. For example, Congress could replace the current earned income credit with a \$5,000 per worker Social Security tax exemption and a \$1,000 per child refundable tax credit. At the same time, Congress could move the federal tax system toward return-free filing.

1. INTRODUCTION

At the outset, it should be noted that the earned income credit is a whoppingly successful program that has enjoyed broad bipartisan support. Largely because of the earned income credit, millions of low-income American workers pay no federal taxes. And the credit provides important income assistance for millions of low-income working families -- especially single-parent, female-headed households.

Unlike most other welfare programs, however, the earned income credit reaches more than 80 percent of its target population./2 And the earned income credit has lower administrative costs than any other welfare program -- just one percent of program costs, according to the General Accounting Office./3

¹ I am co-chair of the American Bar Association Section of Taxation Project on Simplification for Low Income Taxpayers, and I have performed research on the earned income tax credit under the sponsorship of the American Tax Policy Institute, but the views expressed here are my individual views and do not represent the position of any group.

² George K. Yin, John Karl Scholz, Jonathan B. Forman & Mark Mazur, <u>Improving the Delivery of Benefits to the Working Poor: Proposals to Reform the Earned Income Credit Program</u>, 11 American Journal of Tax Policy 225 (1994).

 $^{^{\}rm 3}$ Testimony of Lynda D. Willis before the Senate Finance Committee (June 8, 1995).

Unfortunately, to claim the credit, low-income workers must file unnecessarily complicated tax returns. Not surprisingly, low-income workers frequently make mistakes in claiming their credits, and some taxpayers claim credits to which they are not entitled. In short, because millions of Americans must file tax returns to claim their earned income credits, there are millions of opportunities for taxpayers to make mistakes or to file fraudulent returns.

Consequently, the federal tax system now stands at an important crossroads, and how Congress next amends the earned income credit can change the direction of federal tax policy for years to come. The choice is this: Should the federal tax system move toward having even more individuals file complicated income tax returns, or should the federal tax system instead move in the opposite direction and reduce the number of individuals who must file returns?

Because of the repeated expansion of the earned income credit, more and more individuals must now file tax returns, if only to collect their earned income credit refunds. On the other hand, technological changes -- like information reporting and electronic filing -- have made it possible for the federal tax system to move away from having so many individuals file complicated tax returns.

I believe that Congress should restructure the earned income credit in a way that would reduce the number of individuals who must file complicated tax returns yet would still guarantee benefits for low-income workers. In particular, Congress should consider replacing the earned income credit with an alternative tax or welfare program for low-income workers. For example, Congress could replace the current earned income credit with a \$5,000 per worker exemption from Social Security taxes and a \$1,000 per child refundable tax credit.

II. THE CURRENT EARNED INCOME CREDIT HELPS LOW-INCOME WORKERS

A. BECAUSE OF THE BARNED INCOME CREDIT, RELATIVELY FEW LOW-INCOME WORKERS OWE ANY FEDERAL INCOME TAXES

According to the Census Bureau, more than 39 million Americans live in poverty./4 The principal federal taxes affecting these low-income individuals are the individual income tax and the Social Security payroll taxes. Because of standard deductions and personal exemptions, relatively few of these low-income individuals pay any income taxes.

On the other hand, because the Social Security tax system has no standard deductions or personal exemptions, many low-income individuals are required to pay regressive Social Security taxes. Fortunately, the earned income credit offsets the Social Security tax liabilities of many low-income workers. Consequently, relatively few low-income workers owe any federal taxes at the end of the year./5

For example, consider the tax treatment of a typical family of four in 1995 — a married couple with two children. Assuming that the couple's income consists entirely of wages or salaries, the couple will owe no federal taxes unless it earns more than \$18,370. Basically, the couple's \$6,550 standard deduction and four \$2,500 personal exemptions together will shelter \$16,550

^{&#}x27;Number of Elderly Poor Drops: 'Statistical Anomaly' Cited for Part of the Drop, The Sunday Oklahoman, Dec. 11, 1994, at A24. The Census Bureau estimated the total U.S. population at 259.2 million and the overall poverty rate at 15.1 percent.

⁵ See Appendix for computations.

from the income tax, and the couple's earned income credit will offset the rest of its income and Social Security tax liability. By way of comparison, the poverty level for a family of four in 1995 is just \$15,150.

Thus, in large part because of the earned income credit, relatively few low-income families with children will owe any federal taxes for 1995. The earned income credit is especially important to single-parent families. For example, in 1993, 63.7 percent of earned income credit beneficiaries were heads of household./6 The earned income credit also helps protect childless workers and couples from regressive Social Security taxes.

B. FILING INDIVIDUAL INCOME TAX RETURNS IS BURDENSOME AND EXPENSIVE

Unfortunately, even though relatively few low-income workers owe federal taxes, most must file income tax returns and fill out Schedule EIC to recover their over-withheld taxes and their refundable earned income credits. For example, for the tax year 1992, almost 24 percent of the 113.6 million individual income tax returns filed showed no income tax liability./7 That's roughly 27 million returns, and many of those were filed by low-income workers. Also, that year more than nine million low-income workers received earned income credit refunds in excess of their income tax liabilities./8

Moreover, millions of Americans need help preparing their income tax returns. For example, more than 56 million taxpayers used paid preparers for their 1992 tax returns./9 That's about half of all individual taxpayers. Even more astonishing, 777,000 taxpayers paid private preparers to help them fill out 1040EZ forms, and more than 5.5 million taxpayers paid preparers to help them fill out 1040A forms.

Furthermore, fully half of earned income credit recipients use paid preparers./10 At \$20 or more per return for preparation -- and additional fees for electronic filing and refund anticipation loans, that amounts to millions of dollars going from low-income workers to private preparers. All in all, filing returns is burdensome and expensive for low-income workers and for the IRS./11

⁶ Testimony of IRS Commissioner Margaret Milner Richardson before the Senate Finance Committee (June 8, 1995).

⁷ Internal Revenue Service, <u>Selected Historical and Other Data</u>, 14 SOI Bulletin 175, 205-6 (Winter 1994-1995).

^{* &}lt;u>Id.</u> at 178.

^{&#}x27; Id. at 225.

¹⁰ U.S. General Accounting Office, Earned Income Credit: Targeting to the Working Poor (GAO/GGD-95-122BR) (1995).

¹¹ Indeed, Americans spend at least \$30 billion a year to prepare their individual income tax returns. U.S. General Accounting Office, Internal Revenue Service: Opportunities to Reduce Taxpayer Burdens Through Return-free Filing 1 (GAO/GGD-92~88BR) (1992).

III. SO WHAT CAN BE DONE TO HELP LOW-INCOME WORKERS?

A. SIMPLIFY THE CURRENT TAX SYSTEM FOR LOW-INCOME WORKERS

First, there are a few small changes to the current tax system that could help improve compliance with the earned income credit.

1. Simplify the Current Earned Income Credit

One reform idea would be to modify the 1040 forms so that individuals would no longer have to file a Schedule EIC in order to claim the credit.

Another reform would be to simplify some of the earned income credit eligibility requirements. For example, it would make sense to eliminate the differences between the definition of a "qualifying child" for earned income credit purposes and the definition of "dependent" for purposes of claiming the dependency exemption.

Still another reform would be to simplify the definition of "earned income" that is used to determine the amount of an individual's earned income credit. The current definition of "earned income" includes several items that are excluded from gross income and that are not reported on W-2 or 1099 forms. Most taxpayers eligible for the credit have none of these items, but both taxpayers and the IRS must try to keep track of them. Consequently, one simplification would be to include in "earned income" only those items includable in gross income. Then the credit could be readily computed from information already available on W-2 or 1099 forms and on tax returns.

It might also make sense to limit the earned income credit for self-employed workers to the amount of their self-employment taxes. Under current law, the high level of earned income credit benefits available can actually provide an incentive for low-income individuals to report fictitious amounts of earnings. Such fraud is relatively difficult for wage earners because the IRS can match the employee and employer W-2 forms. Because only a portion of self-employment earnings shows up on 1099 forms, however, it is easy for self-employed workers to overstate their earnings. Consequently, limiting the credit available to self-employed workers may be an appropriate way to curb that abuse (although, admittedly, such a limit would create an inequity between wage earners and self-employed workers).

On the other hand, adding a wealth test to the earned income credit or expanding the credit's definition of adjusted gross income would make the credit even more complicated and so increase the compliance burdens on taxpayers and on the IRS.

2. Let the IRS Prepare Tax Returns for Low-Income Workers

Another reform would be to let the IRS prepare returns for individual taxpayers. Currently, the IRS believes that Office of Management and Budget Circular A-76 prevents it from preparing income tax returns, setting up its own electronic filing network, or designing and distributing computer software that would allow individuals to prepare their returns on their own computers./12

Office of Management and Budget, OMB Circular No. A-76 (Rev.), Performance of Commercial Activities, 48 Federal Register 37,110 (1983). Promulgated by the Reagan Administration, that ruling generally prevents government agencies from "competing" with private-sector businesses.

In particular, it would make sense to let the IRS prepare returns for those low-income workers who claim the earned income credit. Virtually all welfare programs help individuals apply for benefits, and the earned income credit clearly provides a welfare-like benefit. Why not let the IRS prepare returns so that eligible low-income workers can get their earned income credit refunds?

3. Move to a Return-free or a Final Withholding Tax System

Another way to help low-income workers who claim the earned income credit would be to move to either a return-free or a final withholding tax system./13 Under a return-free system, the IRS would prepare tax returns for individual taxpayers based on information reports received from employers and other taxpayer income sources. Most Form 1040EZ and Form 1040A filers and a few Form 1040 filers could elect to have the IRS compute their tax liabilities and prepare their returns -- some 55 million taxpayers in all. Most of these people would no longer have to gather information, become familiar with tax laws, or prepare and file returns. The compliance burdens on the IRS would also be greatly reduced.

Similarly, under a final withholding system, the amount withheld by employers and other income sources is the tax, thus eliminating the need for many taxpayers to file tax returns. Over 30 foreign countries use some form of final withholding, including Great Britain, Japan, Germany, and Argentina. For example, in Great Britain, the income tax is withheld by employers under the British PAYE (Pay As You Earn) final withholding system. When an individual first becomes potentially subject to tax, an initial return must be filed so that the Inland Revenue can determine how much the employer should withhold. Thereafter, individuals with simple incomes and modest earnings are normally required to file a return only about once every five years. In 1991, for example, more than 23 million of the 26 million taxpayers eligible for PAYE did not file tax returns.

Would a final withholding system work in the United States? In its analysis of the issue, the General Accounting Office concluded that most taxpayers who now file 1040EZ returns (about 19 million in 1994) and many of those who now file 1040A returns (about 23 million in 1994) could be served by a final withholding system. Thus, a final withholding system could significantly reduce burdens on both low-income workers and the IRS.

B. REPLACE THE CURRENT EARNED INCOME CREDIT WITH AN ALTERNATIVE MECHANISM TO HELP LOW-INCOME WORKERS

Given the compliance problems with the earned income credit, it is worth considering some alternate ways to distribute benefits to low-income workers. Specifically, eliminating fraud from the earned income credit program may mean replacing it with a floor on Social Security taxes, an employer tax credit, or a direct expenditure program.

1. Replace the Earned Income Credit with a \$5,000 or \$10,000 Social Security Tax Exemption and a \$500 or \$1,000 Per Child Refundable Tax Credit

One alternative would be to replace the earned income credit with alternative tax provisions that could provide similar benefits directly to low-income workers. In that regard, much of

¹³ <u>See generally</u> Internal Revenue Service, Current Feasibility of a Return-Free Tax System (1987); U.S. General Accounting Office, <u>supra</u> note 11.

the complexity of the current system results from imposing Social Security taxes on every dollar of earned income, and then using the earned income credit to offset those taxes for those low-income workers. Wouldn't it be simpler if the federal tax system did not collect Social Security taxes from low-income workers in the first place?

One option would be to add a \$5,000 or \$10,000 exemption to the Social Security tax system./14 Unlike the earned income tax credit, a Social Security tax exemption would reach 100 percent of low-income workers, and it would be less complicated than first collecting Social Security taxes and then using the credit to refund them. Also, unlike the earned income tax credit—which most workers collect around April 15th of the year following their work, a Social Security tax exemption would result in extra money every paycheck. This would be a powerful work incentive./15 Most importantly, neither low-income workers nor the IRS would have to mess with tax returns to get the exemption: Millions of low-income workers would simply no longer need to file tax returns. According to the Joint Committee on Taxation, replacing the earned income credit with a Social Security tax exemption would eliminate over 10 million tax returns annually and free IRS resources for other productive work./16

Of course, much of the benefit of the current earned income credit seems to be geared to providing income assistance to families with children. But it would be simpler to provide that type of family benefit through a refundable child tax credit along the lines of the \$1,000 per child tax credit proposed by the bipartisan National Commission on Children./17 Congress might start by making the \$500 per child tax credit in the Housepassed tax bill refundable./18 A portion of the needed revenue could come from the current earned income credit.

Unlike the earned income credit, a \$500 or \$1,000 refundable child tax credit would not depend upon the marital status of the

[&]quot;See Yin et al, supra note 2, at 280-83. In 1995, workers and their employers must pay Social Security taxes equal to 7.65 percent of a worker's first \$61,200 in wages.

Consequently, a \$5,000 Social Security tax exemption would simply leave \$382.50 a year in the hands of every worker in America and reduce every employer's payroll costs by a similar amount for each employee (\$382.50 = \$5,000 x 7.65 percent).

Security tax exemption would lower the cost of production for employers, thereby increasing their demand for labor. Consequently, a Social Security tax exemption would increase employment opportunities and stimulate the economy -- without driving up the cost of American-made goods.

Joint Committee on Taxation, Present Law Issues Relating to the Earned Income Credit (JCX-24-95) (June 7, 1995).

A New American Agenda for Children and Families 80-88 (1991). The National Commission on Children's proposed credit would be refundable, indexed for inflation, and payment of the credit could take the form of reduced withholding or a tax refund paid annually, or perhaps quarterly. See also Yin et al, supra note 2, at 280-86; Jonathan B. Forman, Reyond President Bush's Child Tax Credit Proposal: Towards a Comprehensive System of Tax Credits to Help Low-income Families with Children, 38 Emory Law Journal 661 (1989).

¹⁸ Contract with America Relief Act of 1995, H.R. 1215, 104th Cong., 1st Sess. § 101 (1995).

parent, nor would it have to be phased out at low levels on income. Consequently, replacing a portion of the earned income credit with a refundable child tax credit could significantly reduce marriage penalties and the work disincentives in the earned income credit's phase-out range.

2. Replace the Earned Income Credit With an Employer Tax Credit

A second alternative would be to replace the current earned income credit with a tax benefit that reaches low-income workers through their employers./19 For example, an employer tax credit could provide tax benefits to the employers of low-wage workers. According to standard economic analysis, these tax benefits would pass through to the low-wage workers in the form of relatively higher wages. Consequently, an employer tax credit would end up helping most of the same low-income workers targeted by the current earned income credit. Yet an employer tax credit would be significantly easier to administer than the current earned income credit, if only because there are far fewer employers than low-income workers.

3. Combine the Earned Income Credit With Other Welfare Programs

A final alternative would be to combine the earned income credit with other welfare programs like food stamps, Aid to Families with Dependent Children (AFDC), and Supplemental Security Income (SSI)./20 The multiplicity of these federal welfare programs has resulted in complexity, inequity, and high administrative costs. Consequently, it might make sense to combine the earned income credit with other federal welfare programs into a single, comprehensive program that could be administered by a single agency. That agency might even turn out to be the IRS, although the Department of Health and Human Services or the Social Security Administration might be more appropriate. Alternatively, the revenues now used for the earned income credit could be bundled together with the appropriations for other welfare programs and revenue-shared out to state welfare agencies. In any event, the administrative savings that would result from combining the earned income credit with other welfare programs could be passed on to beneficiaries in the form of higher benefits.

IV. CONCLUSION

All in all, Congress could restructure the earned income credit in a way that would guarantee benefits for low-income workers and also free millions of Americans from having to file income tax returns. In particular, Congress should consider moving us toward a return-free filing system and replacing the earned income credit with a \$5,000 per worker Social Security tax exemption and a \$1,000 per child refundable tax credit.

See, e.g., Yin et al, supra note 2, at 280-86; Jonathan B. Forman, Improving the Farned Income Credit: Transition to a Wage Subsidy Credit for the Working Poor, 16 Florida State University Law Review 41 (1988); Robert H. Haveman & John Karl Scholz, Transfers, Taxes, and Welfare Reform, 47 National Tax Journal 417, 428-30 (1994).

See, e.g., Jonathan B. Forman, Administrative Savings from Synchronizing Social Welfare Programs and Tax Provisions, 13 Journal of the National Association of Administrative Law Judges 5 (1993), reprinted as Jonathan B. Forman, Synchronizing Social Welfare Programs and Tax Provisions, 59 Tax Notes 417 (1993).

APPENDIX

This Appendix explores the impact of income and Social Security taxes on individuals with incomes at or below the U.S. Department of Health and Human Service's poverty income guidelines./21 Basically, this Appendix shows that in large part because of the earned income credit, many (if not most) low-income workers will have no net federal tax liability in 1995.

Table 1 compares the combined income and Social Security tax thresholds (i.e., net federal tax thresholds) of various family units with their poverty income guidelines./22 As more fully explained below, Table 1 shows that married couples with one, two, or three children have net federal tax thresholds that are above their poverty income guidelines. On the other hand, the smaller and larger family units shown have net federal tax thresholds that are somewhat below their poverty income guidelines.

TABLE 1. POVERTY LEVELS AND MET FEDERAL TAX THRESHOLDS AFTER THE EARNED INCOME CREDIT IN 1995, BY FAMILY SIZE [dollars]

Family s	i	ze
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ROW		1	2	3	4	5	6
1.	Poverty levels:	7,470	10,030	12,590	15,150	17,710	20,270
2.	Simple income tax threshold (before earned income credit):	6,400	11,550	14,050	16,550	19,050	21,550
3.	Income tax threshold after earned income credit:	7,357	11,550	19,386	22,360	23,425	24,490
4.	Social Security tax threshold:	0	0	0	0	0	0
5.	Combined income and Social Security tax threshold (i.e., net federal tax threshold):	4,100	4,100	15,547	18,370	19,245	19,350

Sources: U.S. Department of Health & Human Services, Office of the Secretary, Annual Update of the Poverty Income Guidelines, 60 Federal Register 7,772 (1995) and author's computations.

U.S. Department of Health & Human Services, Office of the Secretary, Annual Update of the Poverty Income Guidelines, 60 Federal Register 7,772 (1995). The poverty income guidelines used here are those applicable to all states (except Alaska and Hawaii) and the District of Columbia.

The table reflects assumptions that all family income consists of wages or salaries earned by a single worker, that families of two or more include a married couple (rather than an unmarried head of household with one or more dependents), that all family members are under age 65 and not blind, and that all family units are eligible for the earned income credit (for example, childless workers are between the ages of 25 and 65). Also, only the employee's portion of Social Security taxes is considered.

Consider a family of four consisting of a married couple and two children. Row 1 shows that the couple's poverty income guideline in 1995 is \$15,150. Row 2 shows the simple income tax thresholds for family units of different sizes. These are determined by summing each family unit's standard deduction and its personal exemptions. For 1995, a married couple with two children could file a joint tax return and claim a \$6,550 standard deduction and four \$2,500 personal exemptions./23 Consequently, the couple would not have to pay any income tax until its income exceeded its \$16,550 simple income tax threshold./24

Row 3 of the table shows each family unit's income tax threshold after taking into account the effect of the earned income credit. The earned income credit is a part of the income tax system which can offset a family unit's preliminary income tax liability. Consequently, taking the earned income credit into account raises the income tax threshold for some family units. For example, taking into account the earned income credit, a typical married couple with two children would not actually owe any income tax until its income exceeded \$22,360./25

On the other hand, because the Social Security tax system has no standard deductions or personal exemptions, family units must pay Social Security taxes starting with their first dollar of earned income. Hence, Row 4 shows that zero is the Social Security tax threshold for all family units.

Finally, Row 5 shows the combined income and Social Security tax threshold (i.e., net federal tax threshold) for various family units. Because the earned income credit is refundable, it can offset not only individual income taxes, but also Social Security taxes. Consequently, a family unit will have no net federal tax liability until the sum of its income tax and Social Security tax liabilities exceeds its earned income credit. For example, a typical married couple with two children would not actually have a net federal tax liability until its income exceeded \$18,370./26

For example, for a married couple with two children with income (I) in excess of its \$16,550 simple income tax threshold but less than the \$26,673 level at which its earned income credit is fully phased out, the couple's income tax liability (T) can be determined by the following formula:

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T = .15 \times (I - $16,550) - ($3,110 - .2022 [I - $11,290]).
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²⁹ Rev. Proc. 94-72, 1994-50 I.R.B. 14.

 $^{$16.550 \}approx $6.550 + 4 \times $2.500.$

²⁶ Algebraically, each computation involved determining the appropriate equation for computing each family unit's income tax liability after its earned income credit and solving for the income level at which that tax liability is equal to zero.

Setting T equal to zero and solving for I shows that the couple's income tax threshold after the earned income credit is \$22,360.

²⁶ Algebraically, each computation involved determining the appropriate equation for computing each family unit's combined income and Social Security tax liability after its earned income credit and solving for the income level at which that tax liability is equal to zero.

For example, for a married couple with two children with income (I) in excess of its \$16,550 simple income tax threshold but less than the \$26,673 level at which its earned income credit

is fully phased out, the couple's combined income and Social Security tax liability (T) can be determined by the following formula:

 $T = .15 \times (I - \$16,550) + .0765 \times I - (\$3,110 - .2022 [I - \$11,290]).$

Setting T equal to zero and solving for I shows that the couple's combined income and Social Security tax threshold after the earned income credit is \$18,370.

Chairman JOHNSON. Thank you. I thank the panel very much for your really excellent testimony.

We are going to recess for about 7 minutes and rush over and vote and come back.

Thanks.

[Recess.]

Chairman JOHNSON. I am going to reconvene the hearing, although my colleagues have not returned. There is the possibility of a series of votes on the House floor. They may have decided to stay and see how that is going to work out. I returned because I have another engagement that I cannot break at 2:30 and I wanted to have a chance to question the panel.

I am going to go ahead and start with my questions and if others do not arrive, we may have to recess again because I know Members do have a lot of interest in the testimony that this panel has

prepared and brought to us.

At least two of you mentioned that there are other ways to provide the subsidy to low income workers that the EITC offers that are preferable. And I am sure that you heard Under Secretary Samuels testify that he felt that the ultimate delivery systems would have the same problems. That eventually you would have to deal with the same issues through using Social Security deductibility and things like that that they are having to deal with currently to assure that the EITC goes only to those who deserve it in the amounts that they deserve it.

I would like you to comment on that. Those of you who recommended—I know Professor Forman did and I cannot remember who else did.

Mr. FORMAN. I think Mr. Steuerle did.

Let me go ahead and comment. I think there will be problems with any type of benefit that is provided in a targeted fashion. I think there is an advantage of the kinds of proposals I made and also Gene Steuerle has made, for example, for a universal refundable child tax credit of \$1,000 per child. Because it is universal, that is because everybody gets it, it does not have to be targeted. You do not have problems of targeting, problems of getting the benefit to the right people because you assume that anybody with a child is a right person.

Most proposals along this line-

Chairman JOHNSON. My understanding is that you are saying, Professor Forman, that a better alternative is the \$1,000 for everyone with no upper-income limit.

Mr. FORMAN. I would not mind having no upper-income limit. I think the phaseout—

Chairman JOHNSON. I know you would not mind but I can tell you from dealing with the \$500 tax credit, it is very expensive and there is absolutely no chance that we could afford to do that.

Mr. FORMAN. You could keep a phaseout at the upper levels. I think what is important in the context of this hearing is that the phaseout not be in this low-income range where it causes marriage penalties and disincentives that discourage low-income people from working. A phaseout at \$100,000 or more of income might make sense.

Frankly, I do not look to the Federal government to help me support my children. My wife and I, are just taking care of things and if the government gives me personal exemptions that is great, for my kids, and if they did not that would be OK, too, if the rates

were not ridiculously high.

Mr. Steuerle. Congressman Petri also pointed out that you could eliminate the personal exemption at higher income levels so that you solve your distribution problem in part. Part of the reason that people want to phase out the credit is that they think that they want to take this device, by itself, and make it progressive. I think what Professor Forman and I and some others worry about is, when you try to make every single item in the Tax Code progressive, one-by-one-by-one, you end up with 5,000 phaseouts and this very convoluted structure. Rather than give upper income levels money, there are alternative ways to acheive overall progressivity.

One way to do it might be to just, if you give a credit at that level, eliminate the personal exemption. Then you solve your distribution. You do not have to fight the battle, oh, we gave the child credit and we gave away to the rich because you took something back from the rich.

But you also then start dealing with some of the other problems such as reducing the marriage penalties, reducing some of the work disincentives that are of concern to a variety of members on this panel.

Mr. Greenstein. If I could comment for a moment on this, too. I think this is a complicated area. There are a lot of things that would go with it. For example, Professor Forman's idea of replacing part of the EITC with exempting the first \$5,000 of payroll taxes. If one did that, a number of the issues one would have to address include replacing the lost funding from the Social Security Trust Fund. The exemption of \$5,000 of the payroll tax would clearly go well up the income scale so one would want to make sure you want redistributing from tax benefits from working families at \$10,000 a year, we are trying to encourage people to leave welfare for work, to people at \$60,000 or \$80,000 a year, let alone at a higher level.

Similarly there is a political question I guess. In Gene and Professor Forman's suggestion, which I think is an interesting one, if it is politically feasible but the notion of converting the personal exemption into a fully refundable credit, regardless of whether a low-income family has earnings, is not one that seems to enjoy support

on Capitol Hill at this time.

If one conditions, as Congressman Petri did, the refundable credit on earnings then you get back into some of the same questions, as Mr. Samuels says, that the EITC has. The final point I would make, I think of all these proposals perhaps the most interesting one to look at is Congressman Petri's. Even his proposal has the following effects.

It transfers some money now going to working families at \$5,000 to \$15,000 a year, mostly one-parent families, to two-parent families up to \$36,000 a year. He raises the break-even on the EITC.

As a result of that, for single-parent families, at \$5,000 a year if they have one child, for example, under his proposal the incen-

tive to leave welfare for work is less than small. The total package that you get if you leave welfare for work is lessened somewhat.

Those are, among the kinds of questions that one has to grapple

with if you do this restructuring.

Chairman JOHNSON. I would appreciate it if you would take the time to tell us your thoughts on Congressman Petri's proposal. I do not have any reason to believe that the Committee is necessarily interested in going that far but I am very impressed by the degree of the marriage penalty in the tax as it is currently structured.

I think that we have been negligent of those kinds of considerations too long. I think the cost of that to our society is now demonstrably extraordinary. I am interested in looking at Congressman Petri's proposal and would be interested in any followup materials any of you care to share with me on that subject.

[The following was subsequently received:]



COLLEGE OF LAW

Nancy L. Johnson Chairman Oversight Subcommittee House Committee on Ways and Means 1136 Longworth HOB Washington, DC 20515

> Re: Joint hearing of the Subcommittees on Oversight and Human Resources, Committee on Ways and Means, on the Earned Income Tax Credit, June 15, 1995

Dear Chairman Johnson:

Thank you again for inviting me to testify about the earned income credit before the joint hearing of the Subcommittees on Human Resources and Oversight on June 15th. You asked my panel to consider the impact of Congressman Thomas Petri's proposal, particularly with respect to the marriage penalty. Here goes.

Description of Congressman Petri's proposal

As I understand his proposal, Congressman Petri would replace the personal exemption for children with an \$1,100 per child tax credit that would be refundable for those with earned income. Then he would change the earned income credit to a credit of \$1,000 per parent, phasing out for single parents between \$9,000 income and \$19,000 and for couples between \$16,000 and \$36,000. He would also eliminate the current earned income credit for childless workers. Congressman Petri's proposal is intriguing, and it merits serious consideration.

The refundable child tax credit

Unlike the current earned income credit, a refundable child tax credit would not create a marriage penalty. As long as the child tax credit is not phased out, there is no incentive to divorce or not marry. For example, a low-income woman with two children could claim two child tax credits, and if she marries another low-income worker with two children, together the couple could claim four child tax credits.

On the other hand, like the current earned income credit, because eligibility for the Petri child tax credit is based on having at least some earned income, the Petri child tax credit would sometimes result in a marriage bonus. For example, when a zero-earning woman with two children marries a low-earning man without children, they would get a large marriage bonus: before neither could claim a child tax credit (or a parent credit), but

Of course, a phase-out of the credit at high-income levels (e.g., over \$90,000) could result in a marriage penalty for certain high-income taxpayers.

² Under the current earned income credit, a marriage penalty of up to about \$5,000 can occur if a low-income woman with two children marries a low-income man with two children: before each could claim the maximum \$3,110 credit, but together they can claim just one, much smaller credit.

together they could claim two child tax credits (and apparently two parent credits as well).

In passing, I should note that under the universal \$1,000 per child refundable tax credit that I recommended in my testimony, there would be neither marriage penalties nor marriage bonuses. For example, a zero-earning woman with two children would get two refundable \$1,000 credits whether she marries or not.*

The parent credit

At the outset, I must say that there is a certain attraction (perhaps even a certain genius) to the Petri parent credit. I like the idea of rewarding the "parenting" of children rather than simply the "having" of children.

Moreover, the Petri parent credit would reduce marriage penalties for most taxpayers; however, because the parent credit would be phased out, some couples would still face marriage penalties. For example, when a parent with \$9,000 of earnings marries another parent with \$9,000 of earnings, they would face a small marriage penalty of just \$200: before each could each get a \$1,000 parent credit, but together they would get just \$1,800 in parent credits. On the other hand, if a parent with \$9,000 of earnings marries another with \$25,000 or more of earnings, they would face a marriage penalty of at least \$1,000: before the parent earning \$9,000 could get a \$1,000 parent credit, but together the couple would get no parent credits, and the \$9,000 would be taxed at the couple's highest marginal income tax rate. Still, the marriage penalty under the Petri parent credit would typically be much smaller than under the current earned income credit.

^{&#}x27;Under the current earned income credit, there are also large marriage bonuses. For example, a large marriage bonus can occur when a zero-earning woman with two children marries a childless man with \$10,000 of earned income: before neither could claim the earned income credit (and he had both an income and a Social Security tax liability), but together they could claim a \$3,110 earned income credit and they will not owe any income tax.

My uncertainty about whether the couple in the text example could claim two parent credits or just one parent credit results from my not knowing whether or not Congressman Petri would require each parent to have earned income in order to claim a parent credit. From his testimony and the accompanying tables, I inferred that as long as one parent was working, each could claim a parent credit. Hence, the couple in the text example could claim two parent credits and two child credits for a total credit of \$4,200.

^{&#}x27; At the risk of trying to close the gate after the horses have left, I might pay for extending refundable child tax credits to parents without earned income with the money that the House welfare reform bill would revenue-share out to state welfare agencies. We already provide welfare assistance to nonworking mothers now through Aid to Families with Dependent Children (AFDC) and food stamps, and the universal \$1,000 per child refundable tax credit that I favor would simply bypass the state welfare bureaucracies.

 $^{^\}circ$ Their combined earnings puts them at \$18,000; that's \$2,000 into the 10 percent phase-out range for married couples (\$16,000 to \$36,000). Of course, if the phase-out range for a married couple were increased to \$18,000 to \$36,000, there would be no marriage penalty at all for this couple.

Also of note, the Petri parent credit would provide larger benefits to married parents than to single parents with the same number of children. For example, a married couple with two children could get two child tax credits and two parent tax credits -- up to \$4,200 in all. On the other hand, a single parent with two children would get no more than \$3,200 -- two child tax credits but just one parent tax credit.

Rightly or wrongly, the current earned income credit does not make such a distinction: both a married couple with two children and a single parent with two children can claim an earned income credit of up to \$3,110 for 1995. It seems to me that if a distinction is to be drawn between married parents and single parents, my inclination might be to give single parents the larger benefit, for example, to help defray their likely greater employment-related child care expenses. Then again, the married couples have another parent to feed, and that alone might justify a larger benefit.

Replacing the personal exemption for children

If a refundable child tax credit is adopted, it could make sense to repeal the personal exemption for children, as Congressman Petri has suggested. Having both a credit and a personal exemption to account for children would be unnecessarily complicated. Also, the revenues associated with the personal exemption for children could be used to help pay for a larger child tax credit.

Eliminating the earned income credit for childless workers

Social Security taxes are regressive, and the current earned income credit for low-income childless workers tempers that regressivity. In my testimony, I suggested that a \$5,000 per worker exemption from Social Security taxes would be simpler to administer. Nevertheless, the current earned income credit for childless workers is better than nothing, so I would not simply repeal it as Congressman Petri has suggested.

Respectfully submitted,

Jonathan Barry Forman Professor of Law

cc: Representative Thomas Petri

⁶ In that regard, I would be inclined to make the dependent care credit refundable (I.R.C. § 21). Jonathan B. Forman, <u>Using</u> <u>Refundable Tax Credits to Help Low-income Families</u>, 35 Loyola Law Review 117, 130-33 (1989).

Also, poverty is a much greater problem for single parents than for couples, and more than 60 percent of current earned income credit beneficiaries are heads of household -- mostly poor working mothers.

Mr. Greenstein. Could I just make a very quick point that the only way that Congressman Petri's proposal is feasible is if Congress is willing to convert the \$500 children's credit into what he does. The only way his proposal is affordable is if he uses the money in that \$500 child credit, the House has passed, and restruc-

tures it into his proposal, but you cannot do both.

Chairman JOHNSON. I understand that. One of the issues that has developed in the EITC is its cost. When you are putting more than twice the amount of money the Federal Government provides for education for children, college students, and graduate students into an income subsidy you had better be very conscious that you are doing it and very confident that you are doing it for the right reasons.

I think we are doing it for the right reasons. I think this is the right policy and I think the testimony of this panel focusing on the interplay among welfare subsidies, minimum wages, the EITC and

FICA and other payroll taxes was very interesting.

I was not aware of the extent to which States had stopped providing welfare to working people. The interaction of the various policies is extremely important. We give it too little attention. That is what interests me about the Petri proposal. I think we have to focus more on interaction. I welcome any thoughts that you have on that.

There are just two other relatively brief questions that I would like to ask you to comment on and then I will yield to my cochair, Mr. Matsui.

First of all, have any of you done any studies about the equity of the EITC State to State?

Mr. Greenstein. Unlike things like AFDC and Medicaid the EITC has the same rules in every State nationally.

Chairman JOHNSON. Well, the reason-

Mr. Greenstein. Because it is true—I think this may be what you are getting at—that the proportion of tax filers who get the credit is higher in some States than in others. That mainly reflects wage structures of the States. In low-wage States a higher proportion of families get it than in high-wage States.

Chairman JOHNSON. Yes. This question comes from my reviewing the material that I was given for this hearing and the tables that show how many filers there are in each State. It was very interesting to me that the New England States with 5 to 6 percent filers were very high cost of living States, were relatively high-wage States but because of our high cost of living what looks like a high wage is not.

It was interesting to me that Alaska, Connecticut, and Hawaii, the three highest cost of living States, have the lowest filing rate. Some of the much lower cost of living but lower wage States have filing rates of 20 percent and more. And we are down to 5 percent.

You look at California, even California is 15 percent. When I looked at who is in that 5 to 6 percent range it is primarily the New England States and others that have remarkably high costs. The older portions of the country tend to have higher costs for a lot of reasons.

I think we do need to think about that. I just wanted to point that out. If any of you have any reflection on that in the future.

Mr. SCHOLZ. Another factor that enters here is that, in States that have State income taxes people tend to be more likely to file Federal income tax returns. I think you will see fewer people in New Hampshire, for instance, file Federal tax returns than you will in States with State tax returns. Another small factor there.

Chairman JOHNSON. That is interesting since Connecticut just adopted an income tax about a year and a half ago, it would be in-

teresting to see if our filing rate goes up.

Mr. FORMAN. Madam Chairman.

Chairman JOHNSON. Yes.

Mr. Forman. The problem that Connecticut has say, in comparison to my home State of Oklahoma which has lower average incomes, is if you have a fixed phaseout and it is relatively low, then the poorer portion of your population will tend to be above that phaseout. On the other hand, a low wage earner in Oklahoma, somebody in the bottom 20th percentile of income in Oklahoma would get the tax benefit credit.

I would say this is a problem of all Federal programs, the personal exemption of \$2,500 this year is worth a lot more to people in Oklahoma where \$2,500 goes further than it does in Connecti-

cut.

Chairman JOHNSON. That certainly is a problem. When you are looking at this particular population we would like to be as equi-

table as possible.

Mr. GREENSTEIN. I was just going to add, I do not know all the details on the Connecticut income tax, but as I recall the level at which a family begins owing State income tax in Connecticut is much higher than in most other States.

Many people in the EITC range probably are not required to file

State income tax in Connecticut.

Chairman JOHNSON. That is a good point, thank you.

Mr. GREENSTEIN. If, as a result of that, they file neither State nor Federal there might be a lower take up rate there than in States where, for example, you start owing State income tax at \$7,000 or \$8,000.

Chairman JOHNSON. My last question you may not want to comment on but it seems to me that key to eliminating abuse in the EITC system is simply eliminating the system of these loans. I

wondered if any of you would want to comment on that?

We have rarely used that instrument of allowing people to, in a sense, borrow against their return and allow middlemen to basically make a profit by reducing the amount of return a taxpayer gets. Since, the whole purpose of the EITC is to expand the incomes of very low earners, it seems unreasonable to allow loan industry participation that diminishes the benefit that the taxpayers are supposed to enjoy.

Any comment?

Mr. GREENSTEIN. I think that is part of it. I think it is part of a larger issue and the larger issue is in any means-tested program the difference between verifying questionable information before payment and having a pure self-certification approach is, in my view, a very large one. If it is pure self-certification the word gets out on the street, that it is pure self-certification.

Prior to this year, if you look at the history of the EITC, prior to 1990, there was not even a schedule, the IRS did not even get on the return some of the basic information that told you whether the person was eligible or not. This Committee financed, and the Bush Treasury Department reformed the credit in 1990 and the results show that they got the errors down some, and started building this scheduled EITC, not until this year did the IRS use the information on the schedule to check, they just made sure that the numbers added up.

Even a year ago, January 1994, on a number of returns they did not check to see if the SSNs of children were accurate. There was no way to check to see if a child was claimed twice. Even for an older child you could write, you had applied for a number and had not yet gotten it from Social Security, and get the credit. There was the easy availability of loans, as you mentioned. There was little system to pull returns that looked questionable and actually verify the way that food stamps or AFDC does before pay out.

The IRS change this year in the EITC, in my view, after following means-tested programs for over 20 years, the single biggest change I have ever seen in 1 year in a program. Now, they check every Social Security number, they check every child's number to make sure no one is claimed twice. You cannot write applied for, you have to actually have a number. Most of these loans have been eliminated.

One of the things that I think is most important is the January 1994 study, that found about a quarter of the benefits being overclaimed, and from that, they erected error-prone categories. You did not hear that much of it from the Treasury because they are a little reluctant to talk about the study in great detail. They do not want people, quite appropriately, to know the details. If your return falls into that category IRS will pull it and send you a questionnaire that requires you to submit verification of various aspects of the claim before they will make the payment.

In my view, that could have a very large effect. In the late seventies, when the Carter administration and I was running the Food Stamp Program, among other food programs, we found that States that did very little verification had much higher error rates. We and the Inspector General went to those States and among the requirements, under threat of fiscal sanction, that we would put on them often were bring on more caseworkers to meet the following amount of verification of questionable cases. Almost uniformly the

error rates went down significantly. Chairman JOHNSON. Interesting.

Mr. GREENSTEIN. When the IRS says, on the back of the Commissioner's testimony here, I notice they did not talk about it, but in the back of her testimony there is a study and what they found in this new analysis is that if they had been doing all the Social Security screens last year that they were doing this year, the error rate that they found or the overclaim rate in that January 1994 would have been down to 19 percent. That does not include, because they cannot measure it yet, the effect of pulling something like a million questionable returns, is what I gather they are doing from this, and verifying data in them before payout. My belief is that when we get all the results in, we will be significantly below 19 percent.

It is still too high and we need to do more. The kinds of things that they have done this year, particularly checking all those numbers, nobody can be claimed twice, and having error-prone categories where you verify before payout, I think that is extremely important.

Chairman JOHNSON. Thank you. I am going to yield to Bob Matsui, my cochairman on the Oversight Committee.

Mr. MATSUI. Thank you, Chairman Johnson.

I want to ask Dr. Kosters a couple of questions. In your testimony—and I am sorry I was not there for your testimony—but you indicate that the EITC is not an incentive to work or it is a disincentive actually to work. Also, we know that 79 percent of every dollar earned over a threshold actually goes into the pockets of the taxpayer.

Now, do you believe basically that tax incentives or incentives in the Tax Code are not of much value or is it just in this particular

case here?

Dr. Kosters. Well, Congressman Matsui, I believe that the work incentives that are built into the EITC and that are said to encourage work, do not really do as much, on balance, to encourage work as is often said to be the case. For those people who are in the phaseout range—the range where for every additional dollar they earn they need to pay an additional tax in order to reduce the size of the credit payment—all of those people are discouraged for work rather than encouraged.

Moreover, the income cutoff is so high that you are getting up into the income distribution to an area where there are lots of people. This is the thick part of the income distribution so much larger numbers are affected in that range, where work is discouraged, than where work is encouraged. So, on balance, I would say that among working families it seems to me that there is general agreement that work is discouraged for them. If you consider in addition nonworking people who might possibly be encouraged to consider working you might get some additional work on balance. Even then, I would say you are likely to get less total output in the economy.

Mr. MATSUI. What about the fact that these people use every dollar they earn for disposable income, very little of it, maybe none of it goes into savings if you are a family of three or four making under \$30,000 a year. That is a first point.

The second point then is when they do work and they get income from that work they are getting more dollars in their pocket. Does that have an incentive to work to it? I mean particularly if it is 79 cents on the dollar?

I mean how could that be a disincentive to work if you need it, because that then prevents you from going into debt for one thing or having to borrow? Why is that not an incentive to work? It seems pretty common sense to me and I do not understand how you reach that conclusion that it is the opposite?

Dr. Kosters. I think you have put your finger on a puzzling aspect of this issue. You might say, well, if people are going to get extra money, surely they will work more no matter what their in-

come level or the implicit tax they pay.

Mr. MATSUI. Well, I mean if it were 10 cents on the dollar, I would say, OK, maybe there is no incentive to work. If it is 79 cents on the dollar, it seems to me, particularly if you need the money—if you did not need the money, if you are making \$200,000 or \$300,000 a year and you do not need the money, then you may not—but if you need the money it would seem that, boy, that is a pretty good incentive to work.

Dr. KOSTERS. Well, for every extra dollar a person earns in that upper range there is, first of all, the 21-cent implicit tax workers could keep 79 cents, presumably, if they were not also in the 15-percent income tax range, plus perhaps State income taxes. Workers probably would not be able to keep quite that much, at least in the upper part of the income range but, below the EITC cutoff.

Moreover, it seems to me that if you do not believe that people are going to respond to work incentives in the upper part of the income range where they receive EITC payments, it is unlikely that people would be encouraged to work in the lower part of the distribution. Consequently, if these incentives produce no encouragement or discouragement to work, that raises a question about why we would not administer these payments completely through other welfare programs if there are no incentive effects. We would then not need to duplicate an auditing bureaucracy which is already in place to administer other programs. We would then not need to expand compliance efforts by the IRS.

Mr. MATSUI. Are you suggesting that we move this to an appropriation?

Dr. Kosters. Yes. As a matter of fact EITC payments are outlays instead of offsets to tax liabilities.

Mr. MATSUI. And you would support that?

Dr. Kosters. Yes.

Mr. MATSUI. You would support 25 dollars' billion worth of ap-

propriations to these people?

Dr. Kosters. Yes, I have suggested that. I think it would be better to administer payments under this program in a different way than through the tax system. Increasingly, as more complexities are added, the EITC looks more and more like the welfare system and it is very difficult for individuals to self-administer such a system. That is why they go to tax preparers, get loans, and so on.

Mr. MATSUI. Frank, it seems just the opposite to me, but I appreciate your comments and all of you. I know my time is running out and we have a vote. But, Mr. Greenstein, much has been discussed about the 1988 TCMP study. Would you just comment on that and explain whether this is an important issue for us to be concerned

about, the so-called 40-percent rate of error?

Mr. GREENSTEIN. The issues it raised are important but the data from the 1988 TCMP is really not relevant today. It does not describe the current situation. Congress in 1990—looking at data from the 1985 TCMP which is very similar to data from the 1988 TCMP—for several months the staff of this Committee, the Finance Committee, Treasury, and the IRS on a bipartisan basis did a major restructuring of the credit. That major restructuring, GAO subsequently did an analysis of it, and pointed out that they had removed the single major source of error from the EITC.

There were some extremely complicated rules on support tests, and household filing status and dependency status that were hard for taxpayers to understand and that IRS could not enforce and those were removed in the 1990 change.

I think the indication that there has been real change is that the 1988 TCMP found that about 34 percent of the credit dollars

claimed that year were overclaimed.

The January 1994 study of a nonrepresentative sample that probably had an above-average error rate had that figure down to 26 percent and the latest Treasury analysis, IRS analysis which is in the Commissioner's testimony, indicates that the current screens they have in place would have reduced it below 19 percent.

That is what I was referring to when I said we appear to have cut the error rate about in half from what it was at the time of the 1988 TCMP. It is still too high, we have got to do more, but

we appear to have cut it about in half.

Mr. MATSUI. I appreciate that answer. I am going to yield to Mr. Cardin.

Mr. CARDIN. Thank you. We only have a minute or two. First let me say that, to my friend Mr. Matsui and to our panelists here, I think on the next panel we have some people who can speak first-hand as to how the EITC was an incentive to work and I think that is the clear record of that effect. One of those individuals is Rhonda Clark, who happens to be from Baltimore, my district. I am not going to be able to be here during your testimony but I want to welcome you to our Committee.

I also would just like to make one point, if I might, for the record. It is interesting that we have been spending all of our time talking about trying to make sure that the error rates are brought down and we all agree on that and we need to change the system to make sure it works efficiently and that only those who are enti-

tled to benefits, receive the benefits.

But we have not been talking much about a large number of people who are perhaps out there who are entitled to the credit who do not avail themselves of the credit. We really have not talked about one of the things that concerns me, which, is that this is a credit that some people are entitled to who do not even know about it. It could be used even more effectively to get people to work and I am not sure that we have taken full advantage of the credit. It is not to diminish the importance of making sure that we reduce the error rates, particularly the fraud rates as low as possible. We should not lose sight of the fact that this is a very valuable program and we should not be timid about making sure it is available to those people who could benefit from it.

I thank the Chairman for yielding to me, and I yield back.

Mr. STEUERLE. Mr. Cardin, if I could just make one addition. To get to your problem, one of the major things you need to do is get to simplification. That has always been a goal. That is a major way you get the EITC to the people who do not yet file for it.

Mr. FORMAN. Mr. Cardin, if I might come back to my proposal which would be for a \$5,000 across-the-board exemption from Social Security taxes. Right now, basically 80 percent of the people eligible for the EITC are claiming it. The other 20 percent are not.

If you actually just said, well, we are just not going to collect the taxes on the first \$5,000 of wages, then the other 20 percent would not have to pay these taxes and would not have to file the EITC to get the benefit back. We could get some benefit in every worker's hands with an across-the-board exemption.

We have exemptions and standard deductions in the income tax system, but the Social Security tax system is a regressive tax sys-

tem that hits people on the very first dollar of wages.

Mr. CARDIN. Thank you.

Mr. ENGLISH [presiding]. Thank you.

Gentlemen, we appreciate all of the testimony you are offering today and your massive expertise as a group. Just a few questions on my end. Dr. Kosters, you suggest in your testimony that the welfare system is already better able to administer the EITC Program than is the IRS.

My question is, do you believe that welfare agencies are better able to track the earnings and assets of an individual, and if the EITC were administered by welfare agencies, would that not mean that low-income earners, many of whom have never dealt with the welfare systems, would be required to deal with welfare agencies

as well as the tax system?

Dr. Kosters. Well, that is an interesting question. There are some people who are getting the EITC who are not dealing with the welfare system, and if we wanted those people to get payments, and right, if kinds of people in different situations might be mentioned, people who are, say, graduate students who might qualify for the EITC, but who are not on welfare. We want those people to get payments. Then they would have to presumably also get them through the same system.

It seems to me that one possible approach to this, though, would be to say, let's have an EITC that roughly compensates people for the payroll taxes they pay up to a certain level, and people who qualify for that can apply for it in the same way it's administered

now.

People who get larger payments in the \$3,000, \$3,500 range, or something like that, those payments should be part of the payment system administered by the current welfare bureaucracy, as re-

formed. Reform is now under way.

Mr. ENGLISH. Dr. Kosters, I know you are doubtlessly familiar with research by Gary Bertless, which seems to show that welfare mothers who can be expected to stay on the roles for an extended period of time, specifically those with little education, low test scores, and very little job experience, usually can find jobs that pay between \$5.50 and \$6 an hour, around \$12,000 a year, and we have a lot of situations like that in my district.

Bertless finds that most of these mothers fail to raise their wages over a 12-year period. These mothers are going to have to make a

go of it on earnings of around \$12,000 a year.

Given the reality that our countries will have millions of lowskilled mothers rearing children for as far into the future as we can see, do you think that it would be better for the mother, for the children, and for society if these mothers are helped to a tolerable standard of living through the EITC provision? I guess expanding on that, is not this strategy far preferable to allowing these mothers to stay on welfare indefinitely?

Dr. KOSTERS. Well, welfare mothers with low-earning capabilities, and in general, as research by Bertless and others shows, wel-

fare mothers do have relatively low-earnings capabilities.

This situation is not a cheery one, whether or not they get EITC payments. It seems to me that in our welfare system, we need to be prepared to provide support to some people. Some will not be in a position to be able to work, and they need to be provided support, perhaps more support than they are now providing.

For others, though, it seems to me, we could differentially treat them, provide them with less support if they are able to work, but

choose not to.

My sense is that the EITC is not going to make a big difference on that choice, and it seems to me it needs to be somewhat more of an administered choice.

With regard to whether or not people's earnings rise, people with relatively low earnings, that data of course comes from a period during the past 15 years or so, when people with low-earning capabilities had declining relative wages and they did rather poorly.

It's no surprise that that also applies to welfare mothers, or previous welfare mothers, people who were on welfare and later on went to work. Those with lower earnings capabilities got very slow increases, like others who had not been on welfare previously.

Mr. GREENSTEIN. Mr. English, if I could just add a word. I think your question hit a very important nail on the head, or both of your questions. The fact of the matter is, most of the families that get the EITC, I think, are not on welfare, and most of them are not graduate students either. Many of them are people who probably will not go to the welfare office, if that is where you have to go to get the credit.

We can take food stamps as an example. The working poor are eligible for food stamps. The income level goes up to modestly over the poverty line. The data show that only about a third, or 40 percent of working families that are eligible for food stamps, actually receive it.

I also think, you know, we know that many mothers work their

way off welfare and some of them slide back on.

I think the EITC helps prevent some of them from sliding back on. If they have to commute to a rural area in a job, in an old car, and the car breaks down, that EITC, we hear, does things like pay for that \$800 car repair, without which they give up the job and they go back onto welfare.

The final point I would like to make is, last week there was a similar hearing to this one at the Finance Committee on the credit,

and the GAO made a very interesting point.

Their point was that, while the noncompliance rate is higher in the EITC than in programs like AFDC or food stamps, it's coordinated with the tax system, so less than 1-percent of the dollars and the credit go for administration. The AFDC, food stamps, and other like programs use 12 percent of all the dollars in the program for administration and EITC.

I disagree with Marv on this. I think we are much better off assisting these people through the tax system than making them go back into the welfare system to get a wage supplement.

Mr. ENGLISH. Thank you, Mr. Greenstein.

Dr. KOSTERS. I wonder if I could just add to that. With regard to costs of administration, it seems to me it would be appropriate to add into those costs the costs of paying tax preparers and of floating loans, which seems to me to be a real cost under the EITC as it is currently administered.

Mr. GREENSTEIN. Well, that is a reduction in the benefit the family gets, and in the absence of the refund anticipation loans, I think the commercial preparers often charge \$30, \$40, or \$50 bucks,

which is a relatively small proportion of the EITC payment.

The additional payment that, fortunately, is now disappearing, are the additional payments lots of people paid for those loans in the past. If they do not get the loans anymore, the advance loans, then they do not have to make that interest payment for the loan.

Mr. ENGLISH. Thank you, Mr. Greenstein, and I want to thank all of you. I have about 15 more questions, but I am afraid the time does not allow us to pose them, and I appreciate this panel which represents more academic expertise on this subject than I have ever seen assembled, taking the time to come here and offer the benefits of your research.

While I am here, at this moment, alone, I want to say that on behalf of all of the Members of the Ways and Means Committee, we appreciate the contribution that you have made to this debate, and I appreciate your coming out today.

and I appreciate your coming out today.

Thank you very much, and I will empanel the next group of witnesses.

We are going to start with the parents who are currently utiliz-

ing the EITC.

I welcome Joseph Antolin, deputy director of the Illinois Department of Public Aid, in Springfield, Illinois, who is accompanied by Sherry Alvarez of Chicago, Illinois, a parent currently utilizing the EITC.

Also with them is Dr. Lynn Olson, director of the Division of Child Health Research of the American Academy of Pediatrics, and a visiting scholar for the Center for Urban Affairs and Policy Research of Northwestern University in Evanston, Illinois.

Also Rhonda Clark of Baltimore, Maryland, who is currently uti-

lizing the EITC.

I understand one or two of you have to make the train, so what I would like to do is start with Sherry Alvarez.

STATEMENT OF SHERRY ALVAREZ, CHICAGO, ILLINOIS

Ms. ALVAREZ. Good afternoon. Thank you for having me.

I am nervous. I am a former recipient of public aid. I am working now. I have been working for 1 year. The tax credit has helped a lot because I have had some—while I was working, I had a crisis, and without the credit, I might have lost my job, and would have had to go back to public aid.

Having the credit helps, because I had the money there to pre-

vent losing my job.

The crisis was a propertyowner where I used to live, he sold the building but he did not give me any notice. The new landlady came, and she gave me 30 days notice to leave.

We had no savings or anything, so it would have been hard to find somewhere for me and my kids to stay, without having the

credit to back me up.

Mr. ENGLISH. Thank you, we appreciate your testimony, and if you want to amplify on that during the question and answer period, we can do that, too, if you prefer.

Ms. ALVAREZ. Thank you.

Mr. ENGLISH. Thank you so much for taking the time to come here and testify from Illinois.

I would like to recognize now, Rhonda Clark, for your testimony, and we appreciate your being here.

STATEMENT OF RHONDA CLARK, BALTIMORE, MARYLAND

Ms. CLARK. I thank you for the opportunity to speak with the Committee today. My name is Rhonda Clark and I live in Baltimore, Maryland. I am a 26-year-old mother of an 8-year-old girl and a 7-year-old boy. I work full time as a receptionist at the Maryland Committee for Children, and the sole support of my two children.

I am a recipient of the advanced earned income credit, which means I will receive about 60 percent of the re-credit in each paycheck. At the end of the year, I file for the remaining 40 percent, and it is a very simple task to fill out one form with the dependents and sign my signature. It is not a very hard process to go through when filing.

My story is not unique. I am like many others you may know, or you may not know. I dropped out of high school when I became pregnant with my daughter. I received my general equivalent diploma, my GED, but I was an AFDC recipient for 3 years until I

went to Project Independence, which provides job training.

Through Project Independence, which is Maryland's welfare-towork program, I learned skills while I worked for a number of organizations, including the Francis Scott Key Medical Center, in the personnel department, and the Baltimore Public Works Museum, as a tour guide and admissions clerk.

In November 1993, I joined the private sector working full time

at the Maryland Committee for Children.

Although you have never met me, you know many others like me. The receptionist who directs your calls, the mother in the grocery store with two children, or the person you pass each morning on the way to work.

The advanced earned income credit is very important to me and my family. I learned about it through my employer and it was easy to apply.

While it is not an answer to all our problems, such as the need for affordable child care and health care, it has been a big help.

Educating the people about the EITC takes place one person at a time. That is why it is important for all of us to spread the word and tell others about the EITC. There are many more people out there who could be getting the help they need, if only they would simply apply for it.

Applying is easy. To get the advanced earned income credit, all I had to do was list my dependents on an application, sign my name, and give it to my employer. The payroll services processed it.

I have my advance earned income credit deposited into a savings account, so that it does not cross my hands, and it does not make me want to spend it right then.

I think it also is a better way of not getting more trouble for myself, giving false information, the information is there in each paycheck.

I enjoy working and I want to continue to work. The EITC gives me some of the help I need to keep working, to stay independent, and to support my family. It is a help I cannot do without.

Thank you.

Mr. ENGLISH. Thank you.

I think what I am going to do, with Dr. Olson and Mr. Antolin's indulgence, is ask the two of you a couple of questions, and then as you need to leave, give you an opportunity to head out, and then I will get their testimony and ask a few more questions.

We very much appreciate all of you taking the time to participate

here today, and improve our understanding of the EITC.

For Sherry Alvarez, I have a question. Rhonda, you had indicated that you first heard of the EITC through your employer. Sherry, how did you find out about it?

Ms. ALVAREZ. Also through a similar program. It is called Project Chance, in Chicago, and I volunteered for their program, to go back to school, and I needed one credit to get my high school diploma. I went back and I got my high school diploma, and she was very helpful.

She told me about the DAC Program, and although I found work on my own, she was very helpful. I learned about the credit from

Project Chance.

Mr. ANTOLIN. Mr. English, if I may, that is the JOBS Program in Illinois.

Mr. ENGLISH. Very good.

Ms. Clark, in your experience, do mothers in the welfare system understand the EITC?

Ms. CLARK. Not truly. A factor is simply that the government is giving them money. This is what most of the people I spoke with talked about. I have done conferences on the EITC in the past, and what we have found is a lot of people do not know why. They have asked me why, actually, and it is easy enough for me to say it is simple, it gives you the incentive to keep working, to stay.

Instead of making \$15,000 that year, you may make \$17,000. It opens a lot of eyes and makes them want to stay. Instead of sitting home watching Oprah, they can be working and making \$2,000 more that year. It is not clear to a lot, but now, the more we have spread the word the past few years, the clearer it is to people, why

they get the EITC.

Mr. ENGLISH. Ms. Alvarez, has that been your experience, too? Ms. ALVAREZ. I believe so. A lot of people do not understand why

they get the credit. I explain that, EITC helps to keep lower income people who have children working.

I guess that is how I explain it. It is for the lower income people with kids. The government wants to keep them working.

Mr. ENGLISH. For both of you, if you were going to take steps to teach mothers about the EITC, what would you look to do? Would

there be a good way of getting the word out, do you think?

Ms. CLARK. I cannot really say what would be a good way. I know that most people that are on AFDC do not know about the earned income credit. They do not know until, just by chance, they get that little flier, and then it may mean nothing to them. They just throw it away because they do not know what it means, or it does not pertain to me because I do not work. I am just here getting my AFDC check cashed.

I would just explain to them that it is to help you stay out there, because in my own crisis, worrying about this credit stopping, it may mean like Mr. Goldstein spoke earlier, sliding back into the AFDC system and that is something that I really do not want.

The EITC I believe would be just that little bit, for people that I speak with, knowing that child care cost is the biggest issue. Child care, to me, is more of an issue than the food program.

Who is going to watch your children? That is the most important and most dearest to your heart. We just need to let the mothers know that the money is there for those purposes, for the food purposes, for the child care, the health care.

Money for emergencies. AFDC recipients do not have money for emergencies. That is how I take advantage of my EITC, by having it put into a savings account for that and child care purposes.

Now that I do have the EITC, when my child care facility decides to go to the beach or bowling, there is that \$5 or \$10 I can pull from my savings to say that they can go, on things that we would never have been able to, otherwise.

It gives the parents the hope that their children can have what

they have.

Mr. ENGLISH. I appreciate your testimony because you have given us a perspective that just is not often heard in the halls of Congress. What I would like to do is bring in now Dr. Olson and Mr. Antolin, and if any of you have to leave because we are running so late with this hearing, feel free to head out.

I very much appreciate your time. Mr. Antolin, can I bring you in now for your testimony, and we very much appreciate your tak-

ing the time to be here.

STATEMENT OF JOSEPH A. ANTOLIN, DEPUTY DIRECTOR, ILLINOIS DEPARTMENT OF PUBLIC AID, SPRINGFIELD, ILLINOIS

Mr. ANTOLIN. Thank you. This is an important issue to us in Illinois, Mr. Chairman, Members of the Committee. On behalf of Governor Edgar and Director Wright, I thank you for this opportunity.

I am the deputy director for the State Department of Public Aid. That means I am responsible for the AFDC, the food stamps, the employment and training program, child support, and welfare re-

forms.

One of the things that we have been trying to do for the last few years in Illinois is change what motivates client behavior to move them to work. It is very consistent with what Congress wants the States to do, and which we think the States can do well.

We have the 6th largest AFDC population and the 26th highest grants. We are a low-grant State, relative to most of our neighbors, and have, as a result, thought about welfare to work somewhat differential the second of the sec

ferently than many of our neighboring States.

We have established waiver programs that got rid of the twoparent penalty, that have made it much less confusing as to what are the incentives to work. The cornerstone of our programs has established a program called Work Pays, which is a State budgeting method to say to welfare clients, it is worth it to go to work, any time, any place, for any kind of job, for however many hours. They are better off, because they keep \$2out of every \$3 that they earn.

In addition, we have integrated the EITC as part of the marketing of Work Pays to our clients to motivate them to go to work.

EITC, Work Pays, and the other sets of AFDC waivers that we call Fresh Start, have combined to move people from welfare to work, and what we are trying to do in Illinois. We have trained our staff on how the EITC works, and some of the nuances of the rules, and how they qualify, so that they can explain to our clients.

That is the income maintenance staff, not the traditional staff

that talk to clients about work-related activities.

The EITC pamphlets and posters from the IRS are in all our of-

fices, and are available next to the public aid offices.

They are handed out as part of the intake package that individuals get, explaining to them what are some of the programs they can benefit from by working.

Our earned income workers, who deal with clients who have earnings, have IRS tax forms on hand and give them to the clients when they have face to face interaction with them, to urge them

to apply for EITC.

All of the Work Pays pamphlets that we have now reference the EITC and the benefits of EITC as well. All of the public presentations, the scripts involved, talk about EITC as well as Work Pays, as if they are part and parcel of the same welfare to work initiative, which is how we are treating them.

There is an annual written notice, in January, that goes to every AFDC client, with their check, telling them about the EITC and the benefits of going to work, and if they have worked in the past

year, that they should be filing for it.

EITC information is part of the video that is playing in the waiting rooms in many of our offices now, along with Work Pays and paternity establishment. They are the three important themes

You might ask what has been the point of that, and various other intermittent things that we have done—media blitzes about

Work Pays and the EITC.

Nineteen months ago, when we started the Work Pays waiver, about 6.8 percent of the AFDC population were working adults.

That accounts for about 14,000 cases in our State. Last month, we had 28,400 families working while they were still on AFDC.

In addition, during those 19 months, we had 35,000 families cancel assistance because they were working.

Our AFDC rolls are going down, our earned income rolls have doubled, and what we are basically seeing is more and more people moving into the work force. Admittedly, many are moving into low

pay, minimum wage jobs, but that is the market reality.

Why we think EITC is so important is exactly that market reality. The jobs that are being created in Illinois often tend to be entry level, minimum wage, or a little bit more than minimum wage, less than full-time jobs, often without benefits.

Work Pays and EITC make it worthwhile for individuals to leave welfare or have a reduced welfare benefit, and go into the work

force.

What Ms. Alvarez did not testify to, if I could add, is that when she started working, there was a modest AFDC supplement. She got a pay raise due to the quality of her work at the insurance company employing her. As a result, she lost AFDC eligibility. She has gotten a subsequent pay raise. EITC has helped smooth through at least two crises that we are aware of.

One, to which she referred, was the eviction where the EITC funding came through in terms of a security deposit and moving

expenses, which she otherwise would not have had.

Let me assure you, before EITC and Work Pays, she would have been back on welfare. The second is that she is being asked by her employer to do some traveling, there is money set aside with this year's EITC refund for a car which she plans to purchase. She could not have done that before, and she could not have done it at her salary.

So EITC Is really making it possible for her to keep working and

expand her responsibilities, and do better.

[The prepared statement and attachments follow:]

STATE OF ILLINOIS DEPARTMENT OF PUBLIC AID

Joseph A. Antolin, Deputy Director

EARNED INCOME TAX CREDIT ADVISORY HEARING

June 15, 1995

Good morning, Chairman Johnson, Chairman Shaw, and members of the Subcommittees on Oversight and Kuman Resources. I am Joseph Antolin, Deputy Director of the Illinois Department of Public Aid. I am responsible for Field Operations, Child Support Enforcement, welfare employment and training programs, and welfare reform demonstrations in Illinois. On behalf of Governor Jim Edgar, Director Robert Wright, and the State of Illinois, I thank you for this opportunity to discuss the Barned Income Tax Credit (EITC) and its integral role in our efforts to move AFDC recipients into the labor force and off welfare.

Illinois is a large, diverse state with the sixth largest AFDC caseload in the nation. Our state has also been a leader in welfare reform by changing the incentives in the system to motivate different behavior. We have integrated EITC into our reforms and our experience. The current EITC program establishes, when used in conjuction with reforms, a powerful financial incentive for clients to work instead of just being dependent on welfare.

1993 FRESH START WELFARE REPORM INITIATIVES

The federal AFDC rules governing work and eligibility are complex and confusing to both clients and staff. They severely limit financial incentives to work, since either after 4 months or twelve months, the AFDC grant is essentially reduced a dollar for every dollar earned. As a result, after a working person's social security and taxes were deducted from income and Medicaid eligibility ended, a working family member was often worse off financially than a person dependent on welfare. To turn these disencentives around, Illinois has implemented a set of federal waivers, policy changes, and a statewide welfare to work marketing program.

In November, 1993, Governor Edgar implemented a multi-faceted federal welfare reform demonstration called Fresh Start. Fresh Start includes statewide waivers to support the family stability and employment potential of two-parent households, and encourage recipients to accept seasonal or temporary jobs; and smaller demonstrations to move homeless families into work, provide job training to at-risk teens before they have a child, and to train unemployed non-custodial fathers so that they could support their children.

However, the main component of Fresh Start, and the centerpiece of Illinois welfare reform is a program we implemented statewide and call Work Pays. The major goal of Work Pays is to give AFDC clients an earned income budgeting system that provides positive, real financial incentives to go to work. Work Pays replaced federal regulations for budgeting earned income (commonly referred to as the "\$30 and one-third disregard"). Work Pays sends a simple message to parents on AFDC that they should be working because it will always be in their best financial interest to do so. Under Work Pays, for every \$3 earned, the AFDC cash assistance grant is reduced by \$1. These grant reductions and the corresponding reductions in the family's food stamps continue until the family has worked their way off welfare.

At the same time Illinois was implementing Work Pays, the federal government was enhancing the value of BITC for working families. Only by going to work could a welfare family obtain the credit. Work Pays and BITC, thus, combined into a powerful incentive for AFDC clients to enter the labor force.

Mork Pays and the BITC have been the catalysts for a fundamental change in the welfare culture in Illinois. Public Ald offices no longer simply determine payment levels and authorize the distribution of assistance checks to "eligible" cases. More than ever before, the emphasis of the caseworker and the Illinois welfare system is to help parents find their way off welfare through work. At every client redetermination and interview, casevokers review the benefits of Work Pays and the BITC. Bach local public aid office now establishes an annual target to increase the level of clients who are employed in that county.

As I will explain in detail, Work Pays and the EITC are the cornerstones of an aggressive effort to sell the idea of employment to both long and short-term welfare clients.

HOW ILLINOIS HAS USED EITC TO PROMOTE EMPLOYMENT AND WELFARE REFORM

EITC is an ongoing, essential part of Illinois' intensive efforts to motivate and move large numbers of AFDC clients into the work force. To illustrate:

In FY'95, Illinois contracted with a not-for-profit organization in Chicago, the Center for Law and Human Services, to train our staff in the BITC and how to promote it to clients. Staff now tell job seekers how the BITC can turn a \$5 an hour job into one worth \$6 an hour.

EITC pamphlets and posters were obtained from the IRS and are readily available to all clients in each of the 142 Department of Public Aid offices in the State. In addition, our earned income budgeting caseworkers have IRS tax forms on hand and encourage clients to file their taxes.

A description of the benefits of the EITC and its role in moving people from welfare to work in conjunction with Work Pays and Fresh Start policies is the focus of our public presentations on Illinois welfare reform to clients, community organizations, and the general public.

The EITC is addressed in detail at all client orientations of the Illinois JOBS Program. In our job readiness sessions with clients, the EITC is discussed as a major incentive for recipients of public assistance to seek, obtain, and retain jobs.

An annual written notice on the benefits of EITC is distributed to all AFDC cases, usually in January. We explicitly emphasize how this program makes work a better option than just welfare.

The EITC has also been a main component in our Work Pays and other welfare reform marketing efforts. Some examples include:

The positive effects of the EITC on an AFDC family who goes to work is a major part of our client Work Pays brochure. Over 150,000 have been distributed since November of 1993.

The BITC is an integral part of our Work Pays video, which is shown on a continual basis in many Department waiting rooms.

RITC calculations are highlighted in our agency Work Pays handout sheets. These give clients tangible examples of how Work Pays and the BITC will really impact their income.

In 1994, the Department placed "Letters to the Editor" from local Department administrators in newspapers throughout the state to explain the thrust of Work Pays and the EITC and the renewed commitment to move people into the work force.

In Spring 1995, the Department hosted two major Work Pays Job Fairs in the City of Chicago. Nearly 4,000 clients volunteered to learn about work opportunities, meet employers, and most importantly, discover how getting a job could benefit their families financially. The Work Pays income disregard, when combined with the additional benefits of EITC, brought home to clients exactly how much their total annual incomes can increase dramatically when they take a job, even a part-time minimum wage job.

What have been the results of this welfare to work effort?

In October, 1993, only 14,144 or 6.8% of the employable AFDC cases in Illinois were reporting earnings from employment. By May, 1995, 28,413 or 13.7% of AFDC cases that include an adult were working. This represents an increase of over 100% in the first 19 months of a 48 month waiver.

In addition, over 35,419 clients have cancelled assistance due to earnings over the same period and Illinois' AFDC caseload has begun to get smaller. I have attached a chart which reflects this tremendous growth in employment. I'd also like to share a map of Illinois which portrays counties which had 20% of the AFDC clients in the workforce prior to Work Pays and to marketing RITC, and contrast with a map of the counties which have at least 20% of the AFDC caseload employed today. These results have exceeded our expectations, but confirm the power of economic incentives in moving people from welfare to work.

We know from client surveys and input from community organizations that the focused marketing of Fresh Start, Work Pays, and EITC have played a major role in this movement to work. Without the availability of the EITC, especially for low wage jobs, these results would not have been achieved as quickly.

NEW EFFORTS AT WELFARE REPORM IN ILLINOIS

To allow us to assist even more individuals to move off welfare, Illinois has embarked on an ambitious plan to further reform welfare in our state. These new initiatives are designed to build on the incentives to work created by the EITC, Work Pays, and Fresh Start, and to strengthen our active efforts to move people into employment and off of public assistance. While we are currently seeking federal waivers to implement some parts of the plan, the basic design put forward by Governor Edgar has four large components:

First, teen mothers, 18 years old and under, must return or stay in school and complete their high school education or obtain a GED to receive AFDC. They will be better equipped to get a job and avoid the risk of long-term welfare dependency. This is known as Illinois' Teen Parent Initiative and is currently in operation in Illinois. Along with case management and supportive services designed to assist these young mothers, parenting classes are mandatory. The Department contracted with 44 community-based organizations statewide to provide case management to over 7,000 teen parents.

Second, parents whose youngest child is 13 or over will be placed in the "Targeted Work Initiative", which has a two year time limit for receipt of APDC without earned income. Many persons in this group are long-term welfare recipients. The program is designed to move clients into any employment, but it is likely it will be in part-time, minimum wage jobs. The BITC will be a key factor in these clients staying with the job as they transition off welfare.

Third, job ready AFDC applicants will be required to participate in job readiness sessions and intensive job search. Seeking employment will be a full-time activity for this group in their initial experience with the welfare system for the first six months.

Fourth, the promotion of Work Pays and the EITC will be closely linked to four aggressive and innovative child support collection initiatives. AFDC recipients will be educated as to how the combined benefits of employment, Work Pays, the EITC, and child support payments, is the best approach to escape poverty.

Illinois has chosen to pursue these reforms even before a block grant is reality, in part, in reliance on the availability of the EITC to make any employment provide financial gain for the family.

RITC AND WELFARE REPORM IN ILLINOIS

The reform initiatives I have described involve nearly 100,000 current and future welfare recipients through FY'96. Due to resource reality and to help clients be responsible for their own futures, Illinois will continue to focus on motivating clients to be their own job developers. A big part of this is first convincing them that, indeed, work does pay. They must recognize that even at entry-level or part-time wages where most welfare clients do start working, it makes financial sense immediately to get and keep a job. When job seekers on public aid understand the financial incentives to be gained, they become much more motivated. Employers with entry-level positions are looking for persons with motivation, and the EITC often provides the "carrot" that makes the difference.

From a policy perspective, the beauty of the EITC is that you have to work to get it. It is not just another welfare "entitlement" that simply pays individuals for doing nothing. As we make the receipt of assistance benefits dependent upon the client's willingness to work, we must ensure and constantly reinforce that they will always be financially better off to do so.

Also, a point that should not be lost in the debate over the EITC is its role in supporting employers. An employer is not expected to be a social service agency. An employer wants a dedicated, enthusiastic employee. No employer wants high turnover at his company, even in entry level positions.

The current EITC program reflects the economic realities of the 1990's. Many of the jobs being created during the current economic expansion are entry level opportunities in service or retail areas. Many offer less than full time hours. However, any job is better than no job. The EITC allows individuals to take jobs that are available, but that they may have previously avoided due to low pay or lack of benefits. Since the economy is creating these jobs, the financial incentives must be in place to expect those on welfare to work and to support their families.

The BITC and initiatives like Work Pays in Illinois help to supplement the low wages necessary in many entry-level jobs. This allows a person, new to the workforce, to meet the day-to-day or unexpected financial needs of their family. At the same time, they can continue to be a valued, ambitious employee. As a person gains experience on the job, wages will usually increase, or they may move to a better job. The experience gained and the need for outside financial supports will progressively lessen and will ultimately disappear for that employee in many, if not most, cases.

HOW EITC HELPED A WELFARE MOTHER TO SELF SUFFICIENCY

Congress often uses tax incentives to encourage certain desirable economic or social activity, and is willing to forego the revenue lost to acheive positive results. The home mortgage interest deduction encourages home ownership because when people own their own homes, the strength and stability of the nation is enhanced. People have a real economic and social stake in the society in which they live. Even more than home ownership, the idea that the able-bodied should work and support themselves is one of the fundamental values that we all hold dear. The main purpose of the EITC is to strongly support that value.

with me today is Ms. Sherry Alvarez who illustrates how the BITC has served its purpose. Hers is a successful testament to how positive public policy can help a family leave the public aid roles and become self-sufficient. She will tell you her own story, but I would like to review the principle facts here.

Ms. Alvarez is a mother of two who received AFDC for approximately five years before her income from employment was sufficient to cancel her public assistance case. During that time, she volunteered for the JOBS program and participated in a Community Work Experience placement at IDPA headquarters in Chicago. Subsequent employment at an insurance company has allowed her to successfully leave the AFDC roles.

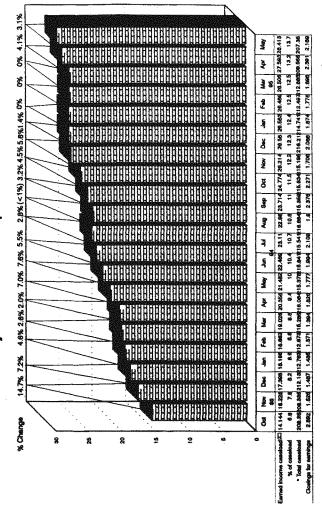
The BITC was a significant factor when a housing crisis arose for the Alvarez family. They were able to provide a security deposit and the first month's rent with funds from the BITC when they were forced to relocate with little notice. Without the BITC, the family would not have had the resources to relocate while Ms. Alvarez continued working. Moreover, if she would have had to interrupt work, she very likely would have returned to the assistance roles.

CONCLUSION

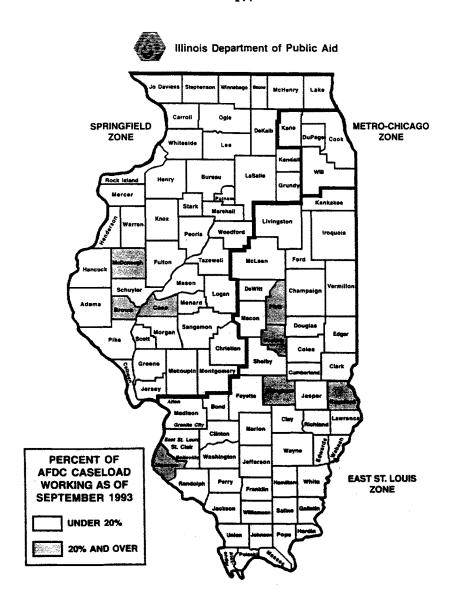
I hope my testimony has adequately explained the critical role EITC plays in the efforts of tens of thousands in Illinois alone who are trying to work to create a better life for their families and to become taxpayers. As you consider making refinements in the EITC, please remember its very important role in getting people off of welfare who are hardworking, but happen to earn low wages.

In sum, welfare reform requires state flexibility to design the programs and to use the tools to make work a real alternative to welfare dependency. We have forged ahead in welfare reform in Illinois through the foundation piece, Work Pays, with the EITC as an integral part of that effort. We have made great strides in Illinois and anticipate you will help us continue moving forward on this path even as you refine EITC. Thank you again for the opportunity to address this Subcommittee.

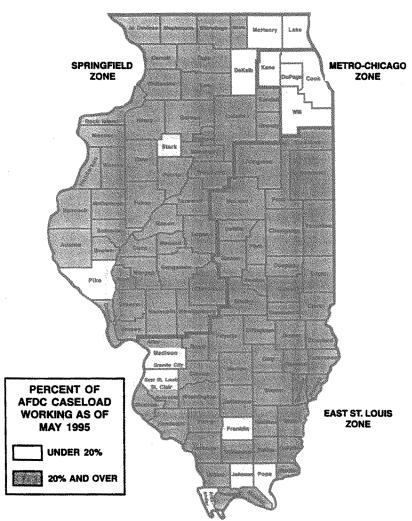
Clients with Earned Income Adjusted BoMB/Operations Numbers



All numbers in thousandths except "% of caseload" * Excludes child only cases & pregnant women only cases.



Illinois Department of Public Aid



Mr. ENGLISH. Well, that is outstanding, and what I would like to do at this point is bring Dr. Olson, who has been very patient, in for her testimony, and we look forward to her contribution.

STATEMENT OF LYNN M. OLSON, PH.D., SENIOR RESEARCHER, DEPARTMENT OF RESEARCH, AMERICAN ACADEMY OF PEDIATRICS; AND VISITING SCHOLAR, CENTER FOR URBAN AFFAIRS AND POLICY RESEARCH, NORTHWESTERN UNIVERSITY, EVANSTON, ILLINOIS

Dr. OLSON. Thank you. I am happy to have the opportunity to talk with you about some of the research I have done on the EITC. My intent today is to use that research to talk with you about what the EITC looks like from the street level perspective of women, particularly in the welfare to work group.

I will address three questions. First, what does the monetary benefit of the credit mean for mothers moving between welfare and work? Second, what do these mothers know about the credit? And

third, how do they go about obtaining it?

I will suggest the following answers are true for many, if not most, of the families in this category. First, the extra funds they receive from the credit are vital to them. Second, the level of misunderstanding about the EITC is very high, and third, these workers are unlikely to have the knowledge or confidence to do their own taxes.

I draw these conclusions from indepth interviews with 30 women across three welfare-to-work programs in Chicago in 1993. I want to point out that these interviews were done before the kinds of things Illinois has recently been doing, that Mr. Antolin talked about.

Clearly, the women greatly valued their tax refunds, which often went to pay pressing bills. "It saved me," said a mother, facing eviction. Others made special purchases they could otherwise never afford, like the downpayment on a used car, purchasing clothing, or furniture for their children.

"I just look around the house and I see what I worked for. I

worked hard, and it felt good."

A few of the more experienced workers were able to make a connection that the credit is one of the benefits they had, now that they were working.

"The earned income automatically affects you in a positive way if you are working. All these incentives, ones with public aid do not

have anything."

However, I found that most could not make this kind of explicit

link between the credit and their own work efforts.

Some people had never heard of the EITC. More commonly, people had heard about it, but, really, they knew little more than that, and what they knew was frequently mistaken. For example, some were not planning to file because they thought they made too little money to do so. Or, because they did not file in the past, they thought they would be in trouble now.

Others believed that the EITC was the same thing as the tax deduction for dependents, or the child care credit, or the credit for being head of household. Another woman believed that this would affect her food stamp benefits negatively. No one we spoke with

had heard of the advanced payment option at that time, and when we explained it to them, they were rather skeptical about it.

I would also point out that there was widespread misunderstanding about the refundable nature of the credit. They did not understand that they were in fact getting additional money from the government, as illustrated by this particular woman, who actually earned so little money that she would not have been paying any Federal taxes.

"Whatever you are supposed to get back, they are still taking out taxes." You get money back, but they have already taken out taxes.

You would hear a lot of, "Well, I am getting my money back." And relatedly, most did not have, really, any idea if working more, or less, would increase or decrease the amount of credit that they were getting.

In summary, it often seemed that people perceived this refund more as an unexplained, very welcome windfall, rather than something that was clearly connected with wages they had earned.

Finally, how do welfare mothers actually go about obtaining their EITC? I think the answer reflects things we have heard today—that many are unlikely to have the confidence or knowledge to actually file their own taxes. Only 4 of the 30 people we spoke with had ever done so, and those tended to be in the past when they could use the EZ form.

A few had vague knowledge of some services like the Vita Tax Clinics, but actually, none of the people had ever used them. In contrast, everybody very clearly knew about commercial tax preparers, where they had gone and paid, at that time, between \$65 and \$100 to have their taxes done, and these frequently included the refund anticipation loans. I think that the dependence on commercial preparers might also reinforce ignorance about the EITC. Clients will tend to hand over their W-2s and expect the agency to do the job for them. "I just let them fill it out and send it back, and whatever comes, if I have got something coming back, it is OK with me."

And in fact a lot of people did not know whether or not the EITC had been claimed for them. We heard a few examples, where clearly, it suggested that some real errors had been made by the preparer.

I would note that since these data were collected, new IRS policies to reduce fraud should also reduce, of course, the use of electronic filing and the refund anticipation loans.

However, I think we can still expect a group that is going to be dependent on commercial preparers in one way or another. That is not going to change.

In summary, as you consider ways to improve the EITC, I would

suggest a few lessons from street level experience.

First of all, the problems of error and fraud in the EITC are apparent and those things do need to be addressed. It is quite unlikely that the women I spoke about today are the people who are the architects of fraud. They clearly would not have the information to be doing that.

Antifraud measures should not create greater barriers for those who are legitimately eligible for the benefits, or make them more dependent on commercial tax preparers.

Second, I would urge that much more attention be given to the

practical realities of how the EITC is implemented.

One of the reasons for the popularity of the EITC has been its very low administrative cost. I would argue, though, that it is unrealistic to think that you can efficiently administer a program that large, to that many people, without some real costs.

The EITC is a very valuable program for these families, and I believe there are real opportunities to improve it. The kinds of things I would suggest would very much dovetail with the things

that Mr. Antolin said.

With that, I will conclude, and thank you for the opportunity. [The prepared statement follows:]

STATEMENT OF LYNN M. OLSON, PH.D. DIRECTOR, DIVISION OF CHILD HEALTH RESEARCH, AMERICAN ACADEMY OF PEDIATRICS, AND VISITING SCHOLAR, CENTER FOR URBAN AFFAIRS AND POLICY RESEARCH, NORTHWESTERN UNIVERSITY, EVANSTON, ILLINOIS

Chairmen, subcommittee members, I am pleased to speak to you about the research I have conducted on the Earned Income Tax Credit (EITC). I am Lynn Olson, a sociologist and a visiting scholar at the Center for Urban Affairs and Policy Research, Northwestern University. I am a senior researcher in the Department of Research, American Academy of Pediatrics. The Academy is very interested in welfare reform and its impact on children, but I speak here today on my own behalf.

My intent today is to suggest what the EITC looks like from the street-level perspective of women in the welfare-to-work transition. This is the group, I presume, you most hope will be helped by the EITC, a refundable tax credit for low-income families. I will address three questions:

- What does the monetary benefit of the EITC mean to mothers moving between welfare and work?
- · What do these mothers know about the EITC?
- · How do they go about obtaining the EITC?

I will suggest the following answers are true for many, if not most, families in the welfare-to-work group: • The extra funds they receive through the EITC are vital. • The level of misunderstanding about the EITC is very high. • These workers are unlikely to have the knowledge or confidence to do their own taxes; they are often dependent on commercial agencies where they pay high fees.

I base these observations, broadly, on several years of experience as a researcher with Project Match, a welfare-to-work demonstration in the inner-city of Chicago. Specifically, these conclusions are drawn from in-depth interviews in 1993 with 30 women in three welfare-to-work programs across the Chicago area. I have also had the opportunity to speak with people around the country involved with the EITC, and their experiences reinforce these conclusions.

Value of the EITC to Very Low-Income Families

The women interviewed in this study had average earnings of only \$7800, which put most of them in the phase-in category where the EITC should certainly operate as a work incentive. Clearly the women greatly valued the tax refunds they received. They reported very quickly using their funds, often to pay pressing bills, as in the case of this mother who was facing the threat of eviction:

"I needed that too. All that went to my rent because I was so backed up paying my rent....It saved me twice. I think this year it's going to do the same thing."

Thus, for many families their tax refund was an essential means of paving over a financial crisis and taking care of bare necessities. Others said they used the funds to make special purchases like a down payment on a used car, new clothing for their children, or furniture:

"I just look around the house and I see different things that I bought....I was able to look at what I had worked for, because I work hard....Last summer – sometimes I wouldn't get off until 11:30 at night and I had to be right back at six that next morning. So I worked hard and I felt good and got that money back."

A few of the women with more knowledge and work experience identified the EITC as one of the benefits they received now that they were working and not on welfare:

"The earned income automatically affects you in a positive way if you're working. If you're on public aid you can't even file it....So I'm getting like \$700 back...So anything I have – if I needed a car, boom, there it is. If my daughter needed clothes that I couldn't handle before, boom, there it is. All these incentives. Ones with public aid don't have anything."

Misinformation About the EITC

However, most of those we spoke with could not make such an explicit link between the EITC and their work efforts. Ideally, for a program to be an incentive people will understand how it works and will know what they are receiving. It appears these optimal conditions are often not met. A handful of women – those who had been in the work force for several years – were quite knowledgeable about the tax system and the EITC. Yet such cases were clearly the exception.

The workers interviewed valued their tax refunds, but that did not necessarily mean they understood how EITC benefits are determined or even that such a program existed. Before we described it to them, some of the women said they had never heard of the EITC. More commonly, respondents said they had "heard of" the credit, but knew little more than that:

"I didn't really know about the earned income—not really. I didn't know it's as much as it is. There's a lot of people that don't know that."

These workers were frequently confused or misinformed about EITC regulations and benefits

"I just heard that if you receive AFDC you might be eligible for it."

"They sent me a thing about how much money! got from unemployment, and they had that (information about the EITC) in there. They had the form, and I read it. It sounded good. But I didn't know how to get it, so it was like, forget it!"

"You can get back up to \$2500, but I got like \$1018 back. I don't know if it was how much I made or actually how they go about doing it."

Interviewees were misinformed about eligibility for the EITC. For some a myth was that they were not eligible and were not planning to file because they made too little money. Another problem was confusion among types of tax credits. For example, some thought the EITC is the same as the tax deduction for dependents or the credit for child care payments or being "head of household." There were other fears about filling. One woman thought she would be in trouble because she had not filed last year. Another was mistakenly concerned it would affect her food stamp allotment.

It was not surprising that no one we spoke with was familiar with the advance payment option. When we explained it to them, most of these workers were skeptica about using this choice. Some said they preferred the forced "savings" of getting a lump sum at the end of the year. Others were fearful that the calculations would not work out correctly and that they would owe the government money at the end of the year, money they would not have.

We explicitly asked several of the women where they thought the EITC refund money came from or what determined the amount they would receive. Many were uncertain, as illustrated by the comments of these two women, each of whom earned so little that they owed no federal income tax:

"Well, some of it has to do with the money they took out and then they gave me so much for my dependent, my son. That's where it came from."

"Whatever you're supposed to get back, they're still taking out taxes. You get money back but they're still taking out a big chunk. They've already took out taxes."

Thus, many did not know that the EITC is in addition to the money they had withheld in federal taxes. In their view they were just getting back the money that had already been taken from their checks. Relatedly, most did not know if working more or less would increase or decrease the amount of credit they received. In sum, I found most women interviewed perceived their tax refund more as an unexplained, but welcome "windfall," rather than as wages they had earned.

Dependence on Commercial Agencies to Obtain the EITC.

How do welfare mothers actually obtain their EITC benefits? Who files their tax returns? My observations indicate many are unlikely to have the confidence or knowledge to do their own taxes. For example, one-third of the women interviewed did not know that April 15th is the deadline to file taxes. Only 4 of the 30 women interviewed had ever completed their own tax forms.

"I don't know about this tax and stuff. She was trying to show me one time so I'd do it myself and I never could figure it out."

A few had vague knowledge of community agencies that might assist in preparing taxes or Volunteer Income Tax Assistance (VITA) clinics staffed by IRS volunteers, but none had ever used these services. In contrast, everyone knew of commercial tax preparers. Most had used such agencies to file their taxes, paying fees between \$65 and \$100 to have their 1040 forms completed, to file electronically, and/or to receive a refund anticipation loan (essentially an extremely high interest, short-term loan so that they could have the use of their tax refund within a few days).

These commercial fees often ate up a substantial portion of the worker's return. In the most egregious case one woman paid \$70 and only received a check for \$30. Many tax agencies appear to target the market of EITC-eligible filers. During tax season storefront offices spring up in low-income neighborhoods. Numerous ads appear on the sides of buses and park benches, enticing people to "Get your refund now!" Television ads offer both fear tactics and enticements. One ad, which aired at the time of our interviews, asking "Who does your taxes?" showed several people expressing fears that if they did their own taxes they might make mistakes. Included was an older African American man who says, "If I did my own taxes I would go to jail because I don't know what I'm doing!" Other pitches were reminiscent of lottery advertising, with images of people lounging in sunny vacation spots.

Clearly the monetary loss is one problem when low-income workers rely on commercial firms to receive their EITC. But I believe there are other reasons to be concerned about this situation. The system reinforces ignorance about the EITC benefit. Clients rely on the agency to do the job right, and apparently receive little consumer information about how their tax refunds are calculated:

"You give them your forms...They fill it out and (you) see what money you get back."

"I was wondering how that works. I never did know that. I just let them fill it out and send it back and whatever comes, if I've got some coming back, it's okay with me."

Many, for instance, did not know whether or not the agency had filed the EITC for them. (During our interviews, copies of interviewees' tax forms were not available, so it was not possible to determine precisely what was or was not done.) From the refund amounts reported it seemed likely that many had been given the credit, even though they had not been told or did not understand what had been done. But a few of the stories we heard suggested the agencies on which low-income workers heavily rely do not always do the job right. Some might not get the full refund to which they are entitled because of the inadequacies of commercial preparers. One of the more knowledgeable respondents explained:

"If you don't already know it they won't tell you anything. They just fill it out. They won't tell you anything. You have to ask them the questions."

Another woman described a similar experience where the preparer was not going to calculate the EITC into her return:

"There's a lot of questions she should have asked and she didn't. I asked her what about the earned income. She didn't mention it. I asked her about the head of household. She didn't mention it either....When she got through with them I was only getting \$700-something and it totally was wrong after she did it. I explained to her why it was wrong and what she did not do."

Once the EITC and head of household credits were correctly computed the woman received a refund of \$1900. Ironically this savvy filer had gone to the agency because she did not trust her own calculations; she wanted to be safe and get a second opinion.

I would note that since these data were collected, actions in 1995 by the Internal Revenue Service (IRS) to hold and check returns where the EITC is claimed should reduce EITC-filers' use of electronic filing and refund anticipation loans. While these new IRS procedures mean EITC filers must wait much longer to receive their refunds I presume they will reduce fraud and errors. The full impact of these changes from the EITC filer's perspective is unknown, but we can assume many will continue to be reliant on commercial agents to prepare their taxes.

Summary and Policy Implications

I believe the EITC is a very valuable program. It supports the hard-fought efforts of low-income working parents to get and stay off welfare and helps them to adequately care for their children. As indicated by your hearing today, there are problems with the system that need to be fixed. I think there is a great opportunity to take action to make certain the EITC reaches those who are eligible and that it is an incentive for families trying to leave welfare.

As you consider these changes let me suggest a few lessons to use from street level experience: First, the problems of errors and fraud in the EITC have received a good deal of attention lately. These issues must be addressed. Given their lack of knowledge about tax rules and procedures, it is quite unlikely the women I spoke about today are among the architects of fraud schemes. While some people who are not eligible receive EITC benefits, there are others who <u>are</u> eligible who do <u>not</u> receive them. Anti-fraud measures should not create greater barriers for those legitimately eligible for EITC benefits. Changes that make filing for the EITC more complicated will increase many workers' dependence on commercial tax preparers.

Second, I would urge that much more attention be given to the practical realities of how the EITC is implemented. It is particularly important to reach the lowest income EITC-eligible families who are likely to be new to the workforce, in the welfare-to-work transition, or on welfare preparing for employment. The promise of very low administrative costs has been one reason for the political popularity of the EITC. But it is unrealistic to think that a program this large – \$15 billion to more than 15 million families in tax year 1993 – can be administered without real cost. Currently low-income workers pay much of that cost in fees to tax preparers. Given the complexity of filing requirements, the EITC in actuality cannot be thought of as self-administered for most. It is not possible for the IRS to function as a social service agency to assist all EITC filers; effective implementation of the EITC will require broad-based efforts by many actors, ideally involving local groups most frequently in direct contact with low-income families.

I believe there are a number of steps that can be taken to enhance the value and efficiency of the EITC; let me suggest a few:

- <u>Develop relevant educational messages and material</u>. The EITC rules and benefits should be presented in clear, concrete terms, for example: "Because of the EITC you wages are now equivalent to \$x\$ per hour." The basic structure of the EITC needs to be better explained and promoted, for example the message that it is a *refundable* credit where you might be receiving far more than any federal taxes deducted from your check.
- Focus education about the EITC throughout the year. Private groups and the IRS
 have done a good job of education and outreach campaigns during the tax filing
 season to urge people to file for the EITC. But if the interest is educating tax payers
 about the EITC, reducing inaccurate claims, and promoting the benefit as a work
 incentive, education needs to be a year-round commitment.
- Integrate EITC education and assistance into work programs. One essential way to reach people year round is in programs where low-wage workers are likely to be

found, e.g., local welfare-to-work programs, Job Training Partnership Act (JTPA) programs, family support programs, and community colleges. Welfare-to-work programs could integrate into their services practical budget planning and clear information on how working will effect various benefits, including how the EITC will affect their paychecks.

• Enhance awareness of the advance payment option. Receiving the EITC through advance payments may provide a greater work incentive because workers will receive a portion of their benefits on a more "real time" basis. If they do not use this option, by 1996 low-income families could receive as much as one quarter of their annual income in a single payment with their tax refund.

Chairmen, that concludes my prepared statement. Thank you for the opportunity to present these ideas. I will be happy to answer any questions you or other members may have.

Mr. ENGLISH. Well, I am delighted that you have given us the benefit of your insights, and I find that we are probably going to have to conclude this hearing shortly.

I have a number of questions for both of you and I guess I would

like to encapsulize them with this.

What should Congress prioritize in making the EITC more accessible to mothers operating on the poverty line, item one?

Item two, what can Congress do to make the program more useful to State welfare departments?

I will start with you, Mr. Antolin.

Mr. ANTOLIN. In terms of reaching more parents, I have to be-

lieve more outreach through employers is still a viable place.

We recently had an experience where we had placed someone in Motorola, not a small company, where the client sought the advance payment of EITC, and the Motorola personnel office had never heard of it, did not know how to do it, and did not believe it was possible.

It took some work with them, with our local IRS staff, to get

them to process it.

That is a problem when you have major employers who react that way, and imagine what it is when you are talking about smaller employers.

There I think is a big part of the marketing that is still needed. As far as with welfare, there are some States that want to do it

as part and parcel of the welfare system.

We think in our State it makes a lot more sense to get individuals moving to work, to get used to filing the tax forms, being part of the mainstream system, the one that you and I——

Mr. ENGLISH. So, you would keep it separate?

Mr. ANTOLIN. Yes. We think there is a huge value in that and would not want to have it added. On the other hand, we like being able to implement it as part of the marketing of welfare to work.

Mr. ENGLISH. Dr. Olson, you have already offered some prescrip-

tions. Do you have anything to add?

Dr. OLSON. There are a lot of specifics that I could talk about, but I think, in general, clearly, there needs to be more education and outreach, and it is not simply done because it really has to be done on a local level.

As Ms. Clark said, it really is about one to one. When it really comes down to it, there is someone there, sitting with their W-2s

and a tax form, and that has to be done somehow.

So it is clearly not going to be easy. It needs to go through the type of places where low-income workers are to be found. The welfare programs are a very important place. Other places are certain categories of employers, community colleges, and Job Training Partnership Act Programs.

Those are the places we need to target. To date, a lot of the education and outreach around the EITC has focused on tax filing, and that has been very effective in many ways. That does not really address the problem of getting people to understand what the credit is, how it really is working, and that is an advantage to them.

Mr. ENGLISH. Thank you.

I want to thank both of you for the substantial contribution you have made to educating this panel on the practical effects of EITC, where the program ought to go, what we ought to be doing with the provision.

This will be one of the most important things that we address during this Congress and you have made a very substantial contribution to this debate and we want to thank you very much, and with that, I would like to adjourn this hearing.

[Whereupon, at 3:05 p.m., the hearing was adjourned, subject to the call of the Chair.]

[Submissions for the record follow:]



The Honorable E. Clay Shaw, Jr., Chairman Subcommittee on Human Resources House Ways and Means Committee B-317 Rayburn House Office Building Washington, DC 20515

Dear Chairman Shaw:

The American Hotel & Motel Association (AH&MA), a federation of state and local lodging associations, represents this nation's lodging industry. Over 45,000 lodging properties with more than 3.3 million rooms and over 1.5 million employees operate in the United States. Our industry's annual sales exceed \$60 billion and our total payroll exceeds \$20 billion. AH&MA's membership ranges from small independent properties to the largest convention hotels. Our membership includes all major resorts and hotel chains.

We offer these comments for inclusion in the record of the June 15, 1995 joint hearing on the Earned Income Tax Credit (EITC) held by your Subcommittee and the Subcommittee on Oversight chaired by Congresswoman Nancy L. Johnson. We believe the EITC has been a valuable tool, targeted to low-wage workers to provide a supplement as they learn, train, and begin their climb up the economic ladder. We believe it is essential to retain the ability of the EITC to meet these goals.

As opposed to an increase in the minimum wage, which is spread broadly across workers whether or not they may need the increase, the EITC specifically helps workers whose earning level and family status warrant support. It contains none of the dampening effects on jobs and job creation which often accompanies an increase in the minimum wage. Additionally, it does not arbitrarily raise the cost of labor to business. The reality today is that in many parts of the county the minimum wage is below the market wages for entry-level employees. In those areas the damage of a minimum wage increase is measured primarily by the ripple effect on wages higher than minimum. Inevitably it distorts the labor market even when minimum wage per se is not an issue. Job creation can be slowed even in those markets. In those parts of the country where the minimum wage accurately reflects the market price for entry level labor, the distortion is more severe. By comparison, the EITC looks not to the market, but instead to the worker and helps only those who truly need help.

Our industry has long supported the EITC and the efforts of Congress to enhance the availability and effectiveness of this program. The EITC addresses several important issues. It strengthens incentives for low-income families to work by supplementing earnings. Work is made more attractive to these families than welfare, and the value of work itself is promoted. As our nation seeks to address the overall problem of welfare, the EITC is one element in that debate. It is important that Congress not weaken the EITC.

As your subcommittees consider the problems that exist with EITC, you are aware of action taken in the Senate to roll back recent changes to the credit. We urge your subcommittees to weigh carefully the best way to eliminate problems and inefficiencies, even fraud to the extent it may exist in the program, and not jump immediately to budget reductions. Eliminating indexing, for example, will increase the tax burden of the working poor and signal a change in the direction of U.S. tax policy. More fundamentally, the message of the value of working and the rewards that come from it will be undermined if harsh restrictions and restructuring happen to the EITC program. We urge you to remember that the EITC is perhaps the most efficient way to provide a targeted, needed supplement to wages.

We commend the efforts of both subcommittees to examine this valuable program. Further, we applaud your commitment to retaining all that is right with this program while considering technical modifications to improve its ability to do what it was designed to: help low-wage earners supporting families learn the value and dignity of work and be encouraged to continue their efforts to enhance their employment potential.

Sincerely,

Jones E. Softige

James E. Gaffigan Vice President, Governmental Affairs

WRITTEN STATEMENT OF THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

INTRODUCTION

The AICPA is the national professional organization of CPAs, with more than 320,000 members. Many of our members are tax practitioners who, collectively, prepare income tax returns for millions of Americans.

The AICPA urges that simplification of the tax system be made a legislative priority. In particular, the EITC is an area in critical need of simplification.

We strongly urge the Committee and Congress to re-write the EITC rules to be understandable and usable by the taxpayers that this provision is intended to benefit - low-income wage earners. This group of taxpayers generally lacks the ability to deal with complex tax laws and is unable to pay for tax preparation assistance. The AICPA welcomes proposed changes to make the credit more effective and offers several suggestions.

BACKGROUND ON THE EITC

The refundable EITC was enacted in 1975 with the policy goals of providing relief to low-income families from the regressive effect of social security taxes, and improving work incentives among this group. According to the IRS, EITC rules affect almost 15 million individual taxpayers.

Over the last few years, the number one individual tax return error discovered by the IRS during return processing has been the EITC, including the failure of eligible taxpayers to claim the EITC, and the use of the wrong income figures when computing the EITC. The frequent changes made over the past twenty years contribute greatly to the credit's high error and noncompliance rates.

In fact, the credit has been changed 10 times (1976, 1977, 1978,1979, 1984,1986, 1988,1990, 1993 and 1994). The credit now is a nightmare of eligibility tests, requiring a maze of worksheets. Computation of the credit currently requires the taxpayer to consider:

- 9 eligibility requirements;
- the number of qualifying children taking into account relationship, residency, and age tests;
- the taxpayer's earned income -- taxable and non-taxable;
- the taxpayer's AGI;
- threshold amounts;
- phase out rates; and
- varying credit rates.

As part of H.R. 831, the House passed last week and the Senate is currently considering a new factor in determining eligibility - the amount of interest and dividends, tax-exempt interest, and net rental and royalty income received by a taxpayer, even if total income is low enough to otherwise warrant eligibility for the EITC.

To claim the credit, the taxpayer may need to complete:

- a checklist (containing 8 complicated questions),
- a worksheet (which has 9 steps).
- another worksheet (if there is self-employment income),
- a schedule with 6 lines and 2 columns (if qualifying children are claimed), and
 - usually, the normal Form 1040 (rather than Form 1040EZ).

For guidance, the taxpayer may refer to 7 pages of instructions (and 39 pages of IRS Publication 596). The credit is determined by multiplying the relevant credit rate by the taxpayer's earned income up to an earned income threshold. The credit is reduced by a phaseout rate multiplied by the amount of earned income (or AGI, if less) in excess of the phaseout threshold.

While Congress and the IRS may expect that the AICPA and its members can comprehend the many pages of instructions and worksheets, it is unreasonable to expect those individuals entitled to the credit (who will almost certainly NOT be expert in tax matters) to deal with this complexity. Even our members, who tend to calculate the credit for taxpayers as part of their volunteer work, find this area to be extremely challenging. In fact, we have found that the EITC process can be a lot more demanding than completing the Schedule A -- Itemized Deductions, which many of our members complete on a regular basis for their clients.

Our analysis suggests that most of the EITC complexity arises from the definitional distinctions in this area. While each departure from definitions used elsewhere in the Code can be understood in a context of accomplishing a specific legislative purpose, the sum of all the definitional variances causes this Code section to be unmanageable by taxpayers and even the IRS. We recognize that many of the additions and restrictions to the credit over the years were for laudable purposes. However, the rules are so complex that the group of taxpayers to be benefited find them incomprehensible and are not effectively able to claim the credit to which they are entitled.

SPECIFIC LEGISLATIVE RECOMMENDATIONS

Simplify definitions and the calculation.

The current rules for the EITC, as previously noted, provide different rules depending upon the number of qualifying children the taxpayer claims. The many rates, thresholds, limitations, and classifications regarding this credit are confusing. For the 1994 tax year, the parameters are as follows:

	1 Child	2 or more Children	No Children
Credit rate (%)	26.30	30.00	7.65
Phaseout rate (%)	15.98	17.68	7.65
Earned income threshold	\$7,750	\$8,425	\$4,000
Phaseout threshold	\$11,000	\$11,000	\$5,000
Phaseout limit	\$23,755	\$25,296	\$9,000
Maximum credit	\$2,038	\$2,528	\$306

RECOMMENDATION: Congress should simplify the definitions and the calculation of the credit. Specifically, as detailed below, we suggest the definitions of qualifying child and earned income be modified. The many rates, thresholds, limitations, and classifications regarding this credit should be referenced to other similar thresholds and classifications throughout the Code. These changes, and the changes listed below, would reduce the number of pages needed for the worksheets, Schedule EIC, EIC Table, and instructions. (See Appendix for specific administrative proposals that we intend to pursue with the IRS to simplify the definitions and calculation.)

Define "earned income" as taxable wages (Form 1040, line 7) and self-employment income (Form 1040, line 12).

The current EITC definition of "earned income" needs to be simplified. Currently, to calculate the credit, the taxpayer must take into account all earned income, including amounts not otherwise reported on the tax return or not taxed. This is one area where numerous errors are made. As GAO states in its September 1993 report GAO/GGD-93-145, Tax Policy: Earned Income Tax Credit: Design and Administration Could Be Improved, "determining the amount of income that should be included in calculating the credit poses a problem for taxpayers and IRS."

Currently, potentially eligible recipients must take into account:

- Taxable earned income (wages, salaries, and tips; union strike benefits; long-term disability benefits received prior to minimum retirement age; and net earnings from self-employment), PLUS
- Nontaxable earned income (defined in the instructions as: contributions to a 401(k) plan and military housing and subsistence, excludable dependent care benefits, pay earned in a combat zone, the value of meals or lodging provided by an employer for the convenience of the employer, housing allowance or rental value of a parsonage for clergy, voluntary salary reductions such as under a cafeteria plan, and "anything of value that is not taxable which you received from your employer for your work").

Furthermore, because taxable scholarships and fellowship grants are reported on Form 1040 line 7, taxpayers are instructed to subtract taxable scholarships or fellowship grants not reported on the Form W-2. This one exception complicates the calculation and is not verifiable, as it is not on the Form W-2.

In addition, as discussed in our administrative recommendations in the Appendix, the earned income calculation does NOT include various other forms of income not on line 7 of the Form 1040 (i.e., welfare benefits, workers' compensation benefits, alimony, child support, unemployment compensation, social security and railroad retirement benefits, pension and annuities, interest and dividends, and variable housing allowances for the military). The exclusion of these items is mentioned in IRS Publication 596, but is not mentioned in the worksheet or instructions. Since these items are taxable, but are not wage income (line 7 of the Form 1040), taxpayers may inadvertently include these items as "earned income".

Currently, the calculation of "earned income" involves a detailed knowledge of tax terminology, such as: "excludable", "taxable", "for the convenience of the employer", and "voluntary salary reductions". The definition of taxable income includes many items not commonly thought of as earnings. In addition, the definition of "nontaxable earnings" is unique to the EITC and is defined in different ways in the instructions and IRS Publication 596 (as addressed in our administrative recommendations in the Appendix). Most people think that "earned income" is wages. Omissions are likely to happen when uncommon terms are used to cover many items that normally are not treated as earnings.

RECOMMENDATION: Congress should define earned income as wages appearing on line 1 of Form 1040, plus self-employment income from line 12 of the Form 1040.

Earned income should only include taxable income, as the statute originally provided when it was created in 1975. As GAO points out, much of "this (nontaxable) income is not reported to recipients or to IRS," and IRS has no way right now of verifying the nontaxable amounts. GAO states, "we do not see a need to provide space on the tax return for nontaxable earned income since less than 3 percent of eligible taxpayers claim (report) this type of income." Therefore, nontaxable income should be removed from the EITC definition

of "earned income" to make the process simpler for the majority of taxpayers who need to complete this worksheet.

We also believe that there should be no exceptions to this taxable earned income definition. If Congress wants to treat taxable scholarships and fellowships different from taxable wages, taxable scholarships and wages should not be reported on line 7 of the Form 1040. Alternatively, if taxable scholarships are to be treated as taxable wages (line 7 of Form 1040), the current EITC subtraction for scholarships and fellowship grants should not be allowed.

Modify the "qualifying child" rules.

According to a GAO analysis, most EITC errors have been linked to issues involving filing status and qualifying children. The qualifying child test is complex. Taxpayers are confused by the "qualifying child" definition and the different definition for a dependent. The definition of "eligible child" complicates the EITC instructions for determining eligibility. The IRS attempts to communicate that a "qualifying child" usually does not have to be a dependent. However, there are a few exceptions that confuse taxpayers. For example, if one divorced parent has custody of the child, but the other parent claims the child as a dependent, the parent with custody can claim the child as a "qualifying child" for the EITC, but can not claim the child as a dependent. Also, if a child is married, the child must be a dependent (i.e., over half of the child's support is provided by the taxpayer) to claim the child as a "qualifying child" for the EITC. This married child exception confuses taxpayers.

Additionally, the different EITC treatment for different taxpayers — depending on the number of children — seems unnecessarily complex, especially for the minor additional benefit derived. The maximum additional credit for more than one child is only \$490. The minor additional benefit is illustrated by an eligible taxpayer with \$4,000 of earned income receiving a credit for one child of \$1,059, while for two or more children, the taxpayer's credit is \$1,208, a difference of only \$149. What is this differential meant to reflect? Clearly, the difference cannot be cost. In addition, there is no EITC difference between taxpayers with two children and taxpayers with three or more children.

Also, taxpayers with and without children are treated differently with regard to their eligibility for the advance ETTC. The advance EITC is available only to taxpayers with qualifying children. There does not appear to be any reason for this difference. The EITC should focus on one goal — earned income.

RECOMMENDATION: The rules throughout the Code, and especially in this area, could be simplified if just one definition was used consistently. Congress should eliminate the distinction between "qualifying child" and "dependent child". Section 32(c)(1)(A)(I), which currently allows the EITC to certain tempayers with non-dependent children, should be changed. If the term "eligible children" is restricted to dependent children, section 32(c)(1)(A)(I) could be cross referenced to section 151.

This definition would provide an easy reference to information already on the Form 1040, line 6, and would eliminate the need for the additional information currently required on the Schedule ElC. We also suggest that the married dependent child test, which is rarely applied, be removed.

Alternatively, if Congress deems that the "qualifying child" is a better definition than "dependent child", then the "qualifying child" test should be used for the dependency exemption as well. Either way, there should be just one definition of child in the Code.

RECOMMENDATION: The spread in the amount of credit for one child and two children should be made more significant than under the current EIC Table. The difference between one and two children in the current table is so small that it could not possibly reflect a cost differential and it is too incomprehensible for it to be a motivating factor in individual conduct.

RECOMMENDATION: Even greater simplification would result if there was no EITC differential based on the number of children. The current three classes of EITC recipients and three considerations at each point in the process are cumbersome. If just one class of EITC recipient existed, the "qualifying child" versus dependent child confusion would be eliminated, making the credit process much easier. In addition, if this recommendation is adopted, all EITC recipients would be able to claim the advance EITC.

As stated previously, an objective of the credit is to remove the regressivity of the social security tax for lower-income individuals. This objective applies to all lower income taxpayers, regardless of the number of children in the home. Thus, eliminating the incremental amount of the credit based on the number of children would not detract from the stated objectives of this provision. The calculation and the EIC Table would be simplified, and the additional information on age and social security numbers of children (currently required on a separate Schedule EIC) would not be needed for the EITC.

RECOMMENDATION: Congress should coordinate all of the Code's tax provisions related to children. These child-based tax provisions include: the incremental child EITC, the child tax credit, the dependency exemption deduction, and the proposed family tax credit in H.R. 1215. All of these child tax benefits should be provided through one mechanism—the dependency exemption. The dependency exemption takes into account the total number of children in the household, versus the EITC, which only accounts for up to two children in a household.

However, since the current dependency exemption is a deduction rather than a credit, the result is regressive (that is, the higher the tax bracket, the greater the tax benefit) at the income levels that the EITC can be claimed. Therefore, if the dependency exemption is to take part of the place of the EITC, one point Congress might consider would be replacing the dependency exemption with a refundable credit, not a deduction. The credit could be refundable and set at a fixed dollar amount per dependent child. This credit could be available in advance from the taxpayer's employer, as is the advance EITC. The per child credit amount could be a round number that is easy to multiply.

The proposed child credit could be phased-out above some threshold AGI that is simple and consistent with other phase-out rules. We suggest that the phase-outs for itemized deductions, personal exemptions, and this proposed child credit all start at the same threshold and that threshold should be a number that is easy to apply — e.g., \$100,000 of AGI. The phase-out mechanism for all tax provisions in the Code should be the same.

4. Combine and expand the denial provisions.

IRS and GAO have stated that many people receiving the credit are not considered "low-income" individuals. As these individuals are identified, greater restrictions are placed on eligibility for the credit, and the computation is made more complex for all EITC recipients. As mentioned earlier, Congress recently agreed to deny the credit to individuals with interest and dividends, tax-exempt interest, and net rental and royalty income in excess of \$2,350. Additionally, the credit currently is not available if the taxpayer: excludes from gross income any income earned in foreign countries, or claims a tax benefit for foreign housing amounts. An individual who owes alternative minimum tax (Form 1040, line 48) is allowed a credit, but the EITC is reduced by any alternative minimum tax. The taxpayer's AGI is used as a limitation for the credit and greatly complicates the computation for most taxpayers.

RECOMMENDATION: We support Congress limiting the credit to those taxpayers originally intended to benefit from the EITC. However, we suggest that this limitation only occur through the denial rules, not the computational rules. We recommend that all the denial provisions be included in one place. The eligibility/denial rules should include the current denial for taxpayers with foreign earned income. We suggest adding to the denial rule all taxpayers subject to AMT. This would delete the computational exception for AMT taxpayers.

Congress also should include in the denial provision taxpayers with AGI that exceeds earned income by \$2,350 or more. H.R. 831's denial for taxpayers with \$2,350 of interest or dividends should be replaced (and essentially combined) with this denial for taxpayers with AGI that exceeds earned income by \$2,350 or more. This exclusion based on AGI would deny the credit to taxpayers with all forms of unearned income (i.e., capital gains, income from partnerships and S corporations, etc.), not just taxpayers with interest and dividends of \$2,350 or more. As the H.R. 831 proposed EITC restriction stands now, these "wealthy" individuals affected by the legislation (i.e., with this type and amount of non-earned income) could charge their investments to earn partnership investment income, capital gains, or pay off their home mortgage and still claim an EITC. If H.R. 831 is enacted as currently drafted, when additional abuses occur. Congress will have to add more restrictions to the EITC statute. However, if our proposed broader AGI denial is used, fewer, or no, additional limitations will be needed. This denial of credit for individuals with higher incomes seems to be the intent of the unearned income restrictions.

An important result of moving the AGI calculation restriction to the eligibility rules is that the calculation would be much simpler. The calculation would no longer require a worksheet.

Specifically, in order to implement this change, we suggest that section 32(h), which currently requires a reduction of the EITC for taxpayers subject to the alternative minimum tax, be modified. On the basis of simplicity, this provision should be combined with section 32(c)(1)(D), denying the EITC to anyone claiming a foreign earned income exclusion. Section 32(c)(1)(D) should also include taxpayers with AGI that exceeds earned income by \$2,350. Section 32(a)(2) should also be modified to remove AGI from the computation. All the restrictions based on income should be contained in one paragraph or subsection, rather than throughout this Code provision.

5. Modify the EIC Table or provide a percentage rate instead of the table.

Although the IRS EIC Table takes into account all the phaseouts, the table can still be a mystery to many taxpayers. Many taxpayers are confused between the EIC Table and the Tax Table.

RECOMMENDATION: Section 32(f) currently requires that the EIC Table have income brackets not greater than \$50 each. Form 1040 instructions currently include two pages of the EIC Table with \$50 brackets, resulting in earned income credit intervals of \$3-\$8. Congress should amend section 32(f) to allow wider brackets which result in greater than \$3 earned income credit intervals. This will reduce the EIC Table to half a page and will minimize the overwhelming nature of the table, and, hopefully, facilitate ease of use.

RECOMMENDATION: We suggest an even bolder alternative — eliminate the EIC Table completely, and instead provide a credit equal to a certain percent (i.e., 10 percent) of earned income. This option could be modified to provide for a few percentage levels (i.e., 30% if earning less than \$8,000, 25% if earning between \$8,000 and \$16,000, and 20% if earning between \$16,000 and \$24,000). This would approximate the average credit currently allowed — \$900 if earning \$3,000 (with 2 qualifying children), \$2,500 if earning \$10,000 (with 2 qualifying children), and \$2,000 if earning \$20,000 (with 2 qualifying children), and sould be much easier to calculate. This would be much simpler and would save space in the instruction booklets and ease much of the confusion. The rates could be written directly onto the EITC line of the Form 1040. This, combined with a changes in the "earned income" definition and AGI limitation, should make the worksheets, checklists, and tables a thing of the past.

OTHER REFORMS TO THE SYSTEM

Lastly, in reviewing comprehensive reform of benefits and tax reform, in general, Congress should consider the problems and complexities for low-earning Americans illustrated above. Some of the reforms listed below have been suggested as a potential solution to the EITC problems.

Use the EITC to eliminate the regressivity of the social security tax, by setting the refundable credit at the current social security tax rate (7.65 percent). The FICA tax regressivity results because the first dollar earned is taxed for FICA purposes, while (for 1994) income generally up to: \$11,250 - married filing jointly, \$8,050 - head of household, \$6,250 - single, and \$2,450 - married filing separately is exempt from the progressive income tax. This option

- would permit all taxpayers with "earned income" to claim this credit regardless of their age, filing status or dependency status.
- Limit the EITC benefit to no more than 15.3 percent (the current self-employment rate) of any self employment income reported. This would address the fraud and overreporting problems involved with self-employment income.
- Exempt the first \$\times \text{ of taxable earned income from the employee's share of social security tax and from \$\times \text{ of the self-employment tax.}\$ (This tax could be administered by adjusting social security withholding and by amending Schedule SE). Exempting low-income individuals from FICA (social security and Medicare) taxes would directly address (with no paperwork) what the EITC was intended to do -- mitigate the regressivity of the FICA taxes.

CONCLUSION

In conclusion, we have identified quite a few areas that need simplification and proposed various means to achieve it. We support measures to eliminate the current EITC problems so that those who legally qualify for the EITC receive it and can claim the benefits in a simplified and easy process.

APPENDIX - Suggested Administrative (IRS) Changes to the EITC Claiming Process

- EITC Line of Form 1040 Should be in the Credits Section of the Form. Even if the
 taxpayer is not allowed to claim the credit, the taxpayer must go through many procedures
 to find out if he/she is ineligible, and then write "NO" on line 56. Line 56 is not even in the
 section of the Form 1040 dealing with credits; it is in the section of the Form 1040 dealing
 with payments. The current placement of the EITC line on the tax return could be confusing
 to taxpayers (although it is in bold). Therefore, we suggest the EITC line be moved to the
 credit section of the Form 1040.
- 2. The IRS Calculation Option Should be Presented at the Beginning of the Checklist and Instructions. IRS currently offers to calculate the EITC for taxpayers, but it mentions the option rather late in the process and requires the taxpayer to supply additional information on a separate schedule. The IRS calculation option is mentioned on the last line of the checklist, which reads "If you want the IRS to figure it for you, enter 'EIC'" on the appropriate line on the appropriate type of Form 1040. IRS should encourage more taxpayers to use this option and should consider mentioning this option at the top of the checklist and instructions.
- 3. All Information Required for the Credit Should be on the Form 1040 —Schedule EIC and the Dependency Exemption Information Should be Combined on the Form 1040. The Form 1040 should provide sufficient information for the IRS to determine if a taxpayer legitimately qualifies for the EITC. The IRS should inform legitimate eligible taxpayers of the correct credit amount. The taxpayer should not have to take the currently required additional steps of reading the instructions and completing the checklist, worksheet, and Schedule EIC.

We agree with GAO's Sept. 1993 report, Tax Policy: Earned Income Tax Credit: Design and Administration Could Be Improved, that stated, "most of the necessary information could be included on the tax return itself. With minor modifications to the dependency and filing status sections of the Form 1040 or 1040A, all the requisite information (the already required child's name, social security number, relationship to taxpayer, and number of months lived with taxpayer, as well as the age and student/disability status of the child) would be available to determine whether a child qualified... We believe taxpayer simplification can be better achieved by the elimination of the separate EIC Schedule, the separate two-page schedule is an additional obstacle for very low-income tax filers." We, therefore, support elimination of the current separate Schedule EIC that merely covers repetitive information, and suggest the necessary information be combined into the existing Form 1040 exemption section, as shown on page 64 of the GAO report. This issue would disappear if a legislative change is made (as we proposed) so that the distinction in number of children is pursued through the dependency exemption.

We also suggest an even easier modification to the Form 1040. The only additional pieces of information (not currently required on the Form 1040) that are requested on the Schedule EIC are: (1) if the child was older than 18 - whether the child was a student under age 24 or permanently/totally disabled, and (2) the child's year of birth. The year of birth could easily take the place of column 2 on line 6c, where IRS currently asks the taxpayer to check if the child is under age 1. Information in (1) could also be included and coded on line 6c (i.e.,

next to the age, put an S if a student and/or D if disabled). If the legislative change we proposed concerning the definition of "eligible child" and dependent is not made, the taxpayer also could put an "E" on line 6c to indicate that the child is an "eligible child" for the EITC. Form 1040 would then include all the information currently requested on the Schedule EIC.

- 4. All Responses on the Checklist Should Consistently Direct the Taxpayer. The current locations and responses to question number 5 on the checklist are confusing to taxpayers and should be switched. Checklist question number 5 should be worded in such a way that a YES response is positive and a NO response results in the taxpayer not qualifying for the credit (similar to all the other seven questions on the checklist). Accordingly, the YES and NO box locations to question number 5 should be switched too.
- 5. The Worksheet Should be Incorporated in the Schedule EIC. If the credit remains as complex as it is right now, instead of a worksheet calculation, the EITC should be calculated on an IRS designed schedule which is attached to the tax return. The Schedule EIC could be modified for this purpose to include the actual computations rather than mere taxpayer identification information. The IRS also could better monitor the credit amounts and if fraud or abuse is involved. It does not make sense for the taxpayer to first complete a checklist, then be directed to the worksheet, then complete the informational Schedule EIC, and then enter the credit from the worksheet onto the tax return. The IRS never sees the worksheet and, therefore, cannot see where the taxpayer made a mistake in the calculation and if it was intentional or not.
- 6. The Description of Items Subtracted from "Earned Income" Should be Stated Similarly in All IRS Publications. All IRS publications should clearly state the same definition and explanation of earned income. Specifically, IRS Publication 596 currently includes a detailed list of items to subtract from earned income, while the worksheet and instructions do not contain this list. The worksheet and instructions should include this list. Taxpayers may inadvertently include these items as "earned income". Specifically, according to Publication 596, the various forms of income that are not included in the earned income calculation (and are not subtracted on the worksheet) are not included in line 7 of the Form 1040 (i.e., welfare benefits, workers' compensation benefits, alimony, child support, unemployment compensation, social security and railroad retirement benefits, pension and annuities, interest and dividends, and variable housing allowances for the military). Our legislative recommendation to define "earned income" as taxable wages (line 7 of the Form 1040) and self-employment income (line 12 of Form 1040) would greatly simplify this problem.
- 7. The Taxpaver Should be Directed to the EIC Table Only Once. Rather than sending the taxpayer to the EIC Table twice (once for earned income and another time for AGI), the worksheet should direct the taxpayer to enter the smaller of the net earned income or the taxpayer's AGI, and then look up that smaller number in the table. The repetitive reference procedure is not necessary if the AGI is less than the beginning of the phase-out threshold. However, if that is the case, the taxpayer should be told to stop once the first credit amount is found in the table, before entering AGI and completing the rest of the worksheet meaninglessly.

Statement of Maria Gomez Commissioner, Department of Ruman Services State of Minnesota

Mr. Chairman, Members of the Committee, thank you for the opportunity to submit testimony for the record on behalf of Governor Arne H. Carlson and the Minnesota Department of Human Services in support of the monthly distribution of the Earned Income Tax Credit.

Minnesota is a state that values work, responsibility, strong families and communities. In our industries and businesses we are a people who work hard, are motivated to achieve, and to innovate. Since 1990, over 100,000 private sector jobs have been created in Minnesota, testimony to the working spirit of our state.

One of the key components of the Minnesota Family Investment Program (MFIP) is to make work pay -- a family should always be better off working than being on welfare. And, even when the economy is good, many of the jobs do not pay enough to support a family. The problem is exacerbated when a family has only one wage-earner. These facts make it very difficult for many people to get off welfare and stay off. They also put many low income persons at risk of needing welfare at some time. In Minnesota, we want to support people in their efforts to become self-sufficient through working -- in other words, to make work pay.

One way of doing this is to make available to low income people the tax credits they have earned in a monthly, rather than a yearly basis. By thus increasing their monthly income, people will be able to avoid welfare altogether or to work their way off of welfare.

In Minnesota, we have begun to put a system in place to make these monthly payments. Beginning January 1, 1996, the TaxCredit Express program will package several state tax credits together into a monthly payment for low income people. We believe that this will be a significant step. It would be greatly enhanced, however, if the federal Earned Income Tax Credit (EITC) could be paid monthly as well. For example, a single parent with two children working full time at an hourly wage of \$5.60 per hour, child care costs of \$350.00 per month, and rent costs of \$400.00 would be able to leave Minnesota's welfare rolls because she would be receiving an additional \$2.87 per hour in monthly credits.

Although employers can pay the credit periodically through their payroll systems, very few do. We will use Minnesota's Department of Revenue to make the payments.

We have consulted with the key federal agencies, and they have advised us that a federal statutory change is needed before we can include the federal credit in TaxCredit Express. The Department of Human Services has consulted with Jimmy L. Smith, National Director of Submission Processing, Leslie B. Samuels, Assistant Secretary of Tax Policy, of the Department of the Treasury, and from David T. Ellwood, Assistant Secretary for Planning and Evaluation in the Department of Health and Human Services, regarding federal barriers to implementing our program. (Their official responses are available upon request.)

Here is how Minnesota's program will work in the first year. Approximately 30,000 wage-earning Aid to Families with Dependent Children (AFDC) recipients who are working would be eligible to apply for the monthly payment of the tax credits. Fifty percent (50%) of the tax for which they are eligible will be paid monthly. We estimate that, collectively, they will be paid \$10.4 million in monthly payments of state tax credits (Minnesota Working Family Income Tax Credit, Minnesota Child and Dependent Care Income Tax Credit, and the Minnesota Property Tax Refund for Renters. They will receive the remainder to which they are entitled after filing their tax return. The computer system that implements AFDC and other programs statewide will provide employment, income, and other verification, with both monthly audits and annual reconciliation. Incorrectly estimated pre-payments will be subject to collection. We plan to expand the program in future years to other low-income persons, using the information and experience of the first year to refine the program. Additionally, although the basic structure would require some alteration, this feature could be easily incorporated into any welfare system the state would develop in response to the changes currently under consideration.

As you can see, Minnesota is uniquely prepared to incorporate the Earned Income Tax Credit into its TaxCredit Express program. This program, especially with the addition of the EITC, will make the difference between welfare dependency and self-sufficiency for thousands of Minnesotans. I urge you to support federal legislation that would enable this program to make work pay.

STATEMENT OF REPRESENTATIVE JIM RAMSTAD WAYS AND MEANS OVERSIGHT AND HUMAN RESOURCES SUBCOMMITTEES JOINT HEARING ON THE EARNED INCOME TAX CREDIT June 15, 1995

I would like to thank both of our distinguished chairs for holding this joint hearing to discuss issues related to possible reform of the Earned Income Tax Credit (EITC).

The EITC, when properly utilized and targeted, can play a role in helping low-income taxpayers get off and stay off welfare.

In this context, I call the Committee's attention to the efforts of the State of Minnesota, which recently passed bold welfare reform legislation to help get families back to work.

The state plan, called the "Taxcredit Express Program," will provide lower-income people with monthly payments of federal and state income and property tax relief. Monthly payments will help families and workers meet their monthly expenses, allowing workers to support their families and avoid welfare or feasibly work their way out of welfare and into financial independence.

I strongly urge members to give their attention to testimony submitted by the State of Minnesota explaining the need for flexibility to enact their progressive approach to helping Minnesota's working families.

Again, I thank the chairs for calling this hearing and all the witnesses for being here today. I look forward to their testimony on the EITC.

IMPACT OF THE BARNED INCOME TAX CREDIT ON GUAM

Statement of Congressman Robert A. Underwood June 15, 1995

Mr. Chairman: Thank you for conducting this important hearing to review the Earned Income Tax Credit (EITC) program. Since the program was established in 1975, it has provided tax credits or direct payments to low income families with children. The EITC provides an incentive for work and is an important bridge between welfare and work. For many working families across the nation, this program has been beneficial in moving people away from dependency and into jobs.

However, I would like to point out how the EITC program affects Guam.

According to the Congressional Research Service of the Library of Congress, about 30 percent of working families with children are eligible for the EITC. When one looks at the demographics in Guam, there are more individuals in the lower rungs of the economic bell curve compared to the nation as a whole. Therefore, the percentage of working families in Guam who are eligible for EITC is double that of the U.S. mainland -- 60 percent. In fact, numerous taxpayers in Guam are taking advantage of the earned income tax credit.

Guam currently uses a mirror image of the Internal Revenue Code as its statutory basis for enforcing tax laws. Unless otherwise exempted, Guam is responsible for implementing tax laws passed by the United States Congress.

The enactment of the EITC is a federal policy which creates a burden on Guam's treasury. This is a federal mandate with no assistance to the local government. For example, during the last four available tax years reported by the Government of Guam's Department of Revenue and Taxation, about \$23 million of general revenue funds were paid for EITC obligations. Yet, no EITC funds were directly appropriated by the federal government to offset this tax burden.

This negative impact of federal policy is similar to the compact impact aid as it applies to Guam. The United States Government signed a compact of free association with certain Pacific island nations over a decade ago. One result of this agreement is that the citizens of these freely-associated states can reside in Guam and become eligible for many social services including welfare payments. Although the federal government was responsible for reimbursing the Government of Guam for about \$50 million in compact-related expenses, less than \$5 million has been appropriated to Guam for compact impact aid. This means that the local government assumes the burden of compliance with compact impact, with little help from the federal government.

The application of the EITC in Guam is currently under review. Congress, in passing the 1986 Tax Reform Act, gave Guam permission to enact its own tax code. We have established the Guam Tax Reform Commission to determine how we will delink from the Internal

Revenue Code. The EITC and its applicability to Guam is one of the issues currently before the Commission. I am hopeful that we will continue to make progress in resolving this and other related tax issues.

Meanwhile, I urge the committee to assess the impact of the EITC on many state and local jurisdictions and to correct the inequities where they exist. We, on Guam, can fulfill our obligation to help working families if the federal government will meet its responsibility to fund this mandate.

Again, I thank you for holding this hearing and request that my statement be made a part of the official hearing record.

United States House of Representatives
Committee on Ways and Means
Subcommittees on Oversight and Human Resources
Hearing on the Earned Income Tax Credit
Washington, D.C.
June 15, 1995

Statement of:

GEORGE K. YIN PROFESSOR OF LAW UNIVERSITY OF VIRGINIA SCHOOL OF LAW

Madame and Mr. Chairmen and Members of the Subcommittees:

In this statement, I explain how the EITC program can be reformed to accomplish its objectives more effectively and efficiently. I am a consultant to the Treasury Department's Task Force on Tax Refund Fraud, and have performed research on the EITC under the sponsorship of the American Tax Policy Institute, a nonpartisan organization interested in promoting sound tax policy, but I submit this statement in my individual capacity and not as representative of any group.

A. Objectives and growth of the program; the continuing problem of noncompliance.

The EITC program provides cash assistance to low-income working families by means of a refundable income tax credit. The program is intended to rebate the payroll taxes of such families and to provide them with greater income security and a work incentive, all very laudable goals. As a result, since its inception, the program has benefited from broad, bipartisan support and,

particularly over the last ten years, it has grown tremendously fast. The following table compares the growth in total federal expenditures for the major means-tested income-support programs between 1986 and 1996:

GROWTH IN FEDERAL EXPENDITURES FOR MEANS-TESTED INCOME-SUPPORT PROGRAMS, 1986-96

Total Federal Expenditures and Growth Rates

Program	1986 spending	1993 spending	1986-93 increase	1996 spending (proj.)	1986-96 increase (proj.)
EITC	2.0	13.2	560%	25.1	1155%
SSI	9.5	20.3	114%	27.0	184%
food stamps	12.5	24.8	98%	n/a	n/a
AFDC	9.2	13.8	50%	14.8	61 %

Source: U.S. House Comm. on Ways & Means, Overview of Entitlement Programs: 1994 Green Book: Background Material and Data on Programs within the Jurisdiction of the Committee on Ways and Means (Comm. Print 1994) at 262 (Table 6-25), 389 (Table 10-21), 704 (Table 16-13), 782 (Table 18-11). All spending figures are in billions of nominal dollars.

The table indicates that since 1986, the EITC program has grown far faster than all of the other major means-tested income-support programs, with the nominal growth in the EITC program between 1986 and 1996 projected to be over 1000 percent. According to these figures, by 1996, federal spending for the EITC program will be over one and one-half times as much as the federal share of the AFDC program.

Unfortunately, the strong support for the program and its rapid growth have not been accompanied by close scrutiny of its basic design and operation, with predictable consequences. There is not yet any reliable data on

noncompliance rates following the major changes to the program enacted in 1993 and first effective in 1994 and subsequent years. But in a study of EITC-related returns filed for tax year 1993 -- when the EITC program was considerably smaller than its projected 1996 levels -- the IRS found an excessive EITC claim rate of about 26 percent (by dollars excessively claimed) and 38 percent (by number of excessive claims), and an underclaim rate of about 1 percent (by dollars) and 6 percent (by claims). If the rate of underclaims represents a very rough indication of the level of inadvertent taxpayer error, these figures suggest an extraordinarily high intentional error rate, in the range of 25 percent of dollars claimed and 32 percent of total claims. Although the 1993 tax year study only involved a small sample of tax returns claiming the EITC and filed electronically during two weeks in January, 1994, the results are consistent with those of earlier IRS studies conducted in 1982, 1985, and 1988. In short, the program has grown very large very quickly, probably too quickly for any agency to administer effectively.

¹See Hearing Before the Senate Committee on Finance on the Earned Income Tax Credit Program, 104th Cong., 1st Sess. (1995) (statement of Margaret Milner Richardson, Commissioner of Internal Revenue) [hereinafter Richardson Finance Committee statement] at Appendix, p.5.

²In its preliminary analysis of the same returns involved in the study, the IRS estimated the intentional error rate to be 12 percent of dollars claimed and 13 percent of total claims, still remarkably high figures. See U.S. Gen'l Acctg. Ofc., Earned Income Credit: Targeting to the Working Poor, GAO/GGD-95-122BR (March 1995), p.15. These estimates were largely based upon the subjective assessment of the reviewing IRS agent as to the reason for the error, see Richardson Finance Committee statement, note 1, at Appendix, p.3, and were not updated in Commissioner Richardson's latest testimony.

IRS Commissioner Richardson has expressed some optimism that studies conducted earlier this year of the 1994 tax year will reflect a declining EITC error rate.³ But whatever the latest statistic, design features of the present program virtually guarantee continuing administrative difficulties in the future. Those features include --

- a sizable cash benefit potentially available to any taxpayer willing to file a claim and to certify himself or herself as eligible;
- administration of the program by an agency, the IRS, whose mission
 has not traditionally included the delivery of welfare-type benefits;
- the existence of tax laws and administrative procedures designed to
 prevent understatements of income, not overstatements;
- a complex but largely unsupervised claims process involving claimants with relatively low levels of education;
- eligibility rules based in part upon complicated family composition and responsibility issues; and
 - constantly changing eligibility standards.

In the following sections, I describe how major reform of the program holds out the possibility of accomplishing its objectives more effectively and with less government waste.

³See Hearings Before the Senate Committee on Governmental Affairs on the Administration, Design, and Effectiveness of the Earned Income Tax Credit, 104th Cong., 1st Sess. (1995) (statement of Margaret Milner Richardson, Commissioner of Internal Revenue), at 13-14.

B. Providing some portion of the EITC benefit as a direct government expenditure.

Most analysts believe that although the tax system promotes higher participation in a welfare-type program like the EITC, the potential for noncompliance is also greater. In other words, the tax system transfers benefits pretty effectively, both to those entitled to the benefit and, unfortunately, to those not so entitled. Indeed, in some research I recently completed with several others, we tentatively arrived at exactly that conclusion. Compared to programs like AFDC and food stamps, we found that the EITC program has a higher participation rate but also a higher noncompliance rate. Thus, if Congress is willing to sacrifice some participation in exchange for improved compliance, it ought to reconsider whether the tax system is the appropriate vehicle to deliver the welfare element of the EITC benefit.

I realize that providing even some part of the EITC benefit as a direct government expenditure rather than through the tax system is contrary to much academic thinking and would have its drawbacks. After all, the tax system is thought to promote participation, eliminate the stigmatizing effect on program beneficiaries, and provide benefits with lower administrative costs than a direct

⁴We found the EITC participation rate in 1990 to be between 75 and 86 percent, or more than recent participation estimates of between 62 and 72 percent for AFDC and between 54 and 66 percent for food stamps. But an EITC ineligibility rate of around 32 percent was considerably higher than excessive claim rates of six percent for AFDC and 7.3 percent for food stamps in FY 1990. See George K. Yin, John Karl Scholz, Jonathan B. Forman, and Mark J. Mazur, Improving the Delivery of Benefits to the Working Poor: Proposals to Reform the Earned income Tax Credit Program, 11 Amer. J. Tax Policy 225, 244, 252-53 (1994).

expenditure program.⁵ But the disadvantages of delivering the welfare element of the EITC through the tax system are also increasingly evident. Aside from compliance considerations, here are some additional reasons to favor delivery through an expenditure program:

1. Consolidation of budget responsibility. -- Under current law, budget responsibility over welfare-type programs is dispersed -- the EITC, for example, is provided through the federal tax system whereas welfare benefits are provided as direct federal and state expenditures. The dispersal of responsibility may promote a wasteful use of government resources. For example, at a recent Senate hearing, a witness testified that welfare caseworkers may actually encourage welfare recipients to file exaggerated EITC claims in order to maximize the amount of EITC benefit available to them.⁶ Quite clearly, there would be no incentive for that particular form of noncompliance if budget responsibility over the EITC program were consolidated with that of other welfare programs.

More generally, Congress is presently considering the conversion of

⁵See Hearing Before the Senate Committee on Finance on the Earned Income Tax Credit Program, 104th Cong., 1st Sess. (1995) (statement of Lynda D. Willis, Assoc. Dir., Tax Policy and Admin. Issues, Gen'l Gov't Div., U.S. Gen'l Acctg. Ofc.) [hereinafter Willis statement] at 7-8 (administrative costs of direct expenditure programs much higher than those of tax system). But the deadweight loss from noncompliance should also be considered in comparing the administrative costs of the two types of programs. Further, as discussed later in the text, the *duplication* of costs would seem, in any event, to be wasteful.

⁶See Hearings Before the Senate Committee on Governmental Affairs on the Administration, Design, and Effectiveness of the Earned Income Tax Credit, 104th Cong., 1st Sess. (1995) (statement of Donald R. Huston).

various entitlement programs benefiting low-income households into block grant programs to be administered by the states. In that consolidation effort, Congress ought not to overlook the EITC program. As currently designed, the EITC program is an open-ended entitlement program administered by the federal government. Claimants meeting the conditions of the tax statute and, indeed, far too many who don't meet those conditions, are "entitled" to the EITC cash benefit. It may well be that Congress wants to confer "preferred" status on the EITC program and maintain its entitlement nature. But that judgment should be made affirmatively, and not by default due to the fact that the program is part of the tax system. If integrated with the welfare system, the EITC program could be a valuable source of funds to finance work initiatives to be administered by the states.

2. Elimination of duplicate government bureaucracies. -- Perhaps the most important group of EITC recipients are those who are still receiving some amount of welfare benefits. They are likely to be very poor, yet may be trying to work themselves off of welfare. Unfortunately, such families must encounter two bureacracies, the IRS and the welfare system, to receive the benefits to which they are entitled. Indeed, because of the EITC program, the IRS is gradually duplicating the large and well-developed bureaucracy already in existence in the welfare system to deal with questions of eligibility. Integration of some portion of the EITC program with the welfare system would eliminate this wasteful duplication of tasks.

To illustrate the problem, consider the rough "wealth test" recently enacted by Congress as a condition for EITC eligibility. As the subcommittees know, welfare programs have long contained far more precise (and restrictive) wealth and asset limitations for welfare eligibility. It would be much more efficient for a single bureaucracy to administer appropriate wealth and asset restrictions for both types of benefits under a single set of rules.

In fact, if it is not soon consolidated with welfare programs, I predict the EITC program will shortly require more refinements requiring the use of further IRS resources. For example, some of my law students this past year, some with responsibility for young children and some without, discovered that working for six to eight weeks during the summer at Wall Street law firms made them newly eligible for the EITC benefit. This is a surprising result given the high rate of compensation for their work, the \$80,000 per year or more some of them will earn right after graduation, the support provided to some of them by relatives and friends while in school, and the *potential* of such support available to some of them from their wealthy families. Yet because EITC eligibility relies upon the income of the tax filing unit, which does not include household or parental resources and income (other than income of a spouse), and considers only current

⁷See the Self-Employed Health Insurance Act of 1995, P.L. 104-7, § 4 (1995) (denying the EITC to taxpayers whose combined taxable and tax-exempt interest, dividends, and positive non-business rents and royalties for the taxable year exceed \$2,350).

^{*}For example, AFDC recipients generally may not have more than \$1,000 in resources, not including the value of their home and certain other basic maintenance items. See 42 U.S.C. § 602(a)(7)(B) (1994); 45 C.F.R. § 233.20(a)(3)(i)(B) (1993).

levels of annual income, my students are eligible for the benefit. In contrast, most welfare programs at least consider the income and resources of other persons in the same household as the recipient in determining eligibility, make eligibility decisions based upon monthly information, and bar certain full-time students from receiving benefits altogether.

Let me make plain to the subcommittees that I am *not* urging enactment of a new, "anti-law student" condition to EITC eligibility although that may be the unintended consequence of my testimony. I am simply using the example as an illustration of the type of refinements to the EITC program that may be necessary if Congress really wants to target that benefit for the truly deserving. Why require the IRS to enforce all of those rules when they already exist and are being implemented by comparable spending programs?

3. Improving the effectiveness of work incentives. — A final factor concerns the effectiveness of the EITC as a work incentive, and here, let me relate to the subcommittees a recent experience I had observing a low-income taxpayer being provided tax return assistance by a VITA volunteer. At the outset, the taxpayer expressed concern that because she had had only a small amount of taxes withheld during the year, she might owe some money to the IRS. After examining her situation, the VITA volunteer proceeded to inform her that she was entitled to about a \$2,000 refund from the IRS. Members of the subcommittees, I wish I were capable of describing for you the look on that woman's face.

Now that was obviously a very pleasant piece of information for the volunteer to convey and the taxpayer to receive. But I kept thinking about the work incentive effect of the \$2,000. Did the money have any effect on her decision to work, or to continue and increase her work effort? Or was it perceived simply as a return of overwithheld taxes, a product of the VITA volunteer's ingenuity, or as former CBO director Robert Reischauer once commented, a windfall like a winning lottery ticket, all of which might, in fact, induce less work in the future? In short, because the EITC benefit is delivered through the tax system, which is a mystery to most Americans, because well over half of EITC recipients obtain some type of assistance in filing their tax return, and because virtually all recipients obtain the benefit as a lump sum rather than periodically in their paychecks, it is not at all clear what the recipients comprehend when they receive their EITC check, with resulting uncertainty as to the labor supply effect of the credit. If the benefit were provided as a direct expenditure, the critical link between work and reward could be made more clear.

C. Redesigning the EITC program within the tax system.

Assuming the EITC benefit will continue to be provided through the tax system, what other design changes might eliminate waste and improve its

⁹See Steven Mufson, Clinton's Social Safety Net: A Bigger Tax Credit, Washington Post, Mar. 6, 1993, p. A1.

¹⁰See U.S. Jt. Comm. on Tax'n, Present Law and Issues Relating to the Earned Income Tax Credit (JCX-24-95), June 7, 1995, at 11.

effectiveness? Here are two ideas. First, Congress could replace much of the program with an exemption from the payment of payroll taxes on the first \$5,000 or \$10,000 of wages.¹¹ The exemption might apply to the employee or the employer's portion of those taxes, or both. As the subcommittees know, the EITC originated in part as an effort to rebate to low-income workers the payroll taxes collected from them. Instead of collecting such taxes and then trying to return those amounts to workers in the form of the EITC, it would make much more sense simply to refrain from collecting the payroll taxes in the first place.

The beauty of this idea is that an exemption could be easily administered by employers through an adjustment to the payroll tax withholding tables. Taxpayers would not need to file returns to get the benefit -- the ultimate simplification for them -- so participation levels would be high. Further, the link between work and reward would be more evident because the benefit would arise in each paycheck rather than as a lump sum at the end of the year. Finally, compliance could be expected to be very high because there would be no net cash benefit being transferred by the government back to taxpayers. Hence, the incentive to commit fraud to obtain the benefit would not be nearly as strong as under the current program.

To be sure, many in Congress might be fearful of tampering with the Social Security system. They might object to a proposal that decouples the link

¹¹See George K. Yin & Jonathan B. Forman, Redesigning the Earned Income Tax Credit Program to Provide More Effective Assistance for the Working Poor, 59 Tax Notes 951 (1993).

between Social Security taxes and benefits. The reality, however, is that for low-income workers, the EITC program has *already* decoupled the link between taxes and benefits. Such workers ostensibly pay Social Security taxes, and thereby become entitled to Social Security benefits, even though the EITC payment completely reimburses them for their Social Security contributions. They, in effect, pay *no* Social Security taxes yet are entitled to receive Social Security benefits. My proposal is simply to accomplish the exact same result but in a direct fashion, by not collecting the Social Security taxes in the first instance.

Another reform idea is to provide some of the EITC benefit to low-income workers through their employers.¹² For example, a tax credit could be awarded to the employer of certain qualifying workers. The theory is that the same general transaction -- the hiring and compensation of a qualifying worker -- can be subsidized by providing a direct benefit to *either* the employer *or* the worker in the transaction if the benefit is capitalized in the compensation arrangement.

Once again, the advantage of this idea would be to simplify administration of the program. It would be easier to administer because of the far fewer numbers of employers than workers. Further, employers are more used to dealing with the IRS than are low-income workers so that at least noncompliance due to unintentional errors should be reduced. Finally, the greater dollar amounts involved per-employer rather than per-worker would make IRS enforcement efforts more cost-effective. In a sense, this idea would convert part of the EITC

¹²See Yin et al., note 4, at 286-94.

program into a mini-block grant program to be administered by the business community rather than by the federal government.

True, the experience with a similar employer tax credit, the targeted jobs tax credit (TJTC), has not been very positive. But a number of features unique to the TJTC program -- its start and stop history, the limited duration of the subsidy to a portion of first year wages, the highly targeted nature of the subsidy directed towards individuals like ex-convicts who are undoubtedly the subject of negative stereotyping, to name a few -- may help to explain that program's ineffectiveness. In contrast, a broadly applicable, employer-based subsidy program which is permanent has the potential for avoiding many of the TJTC's pitfalls.

D. Disentangling the EITC program.

Perhaps the optimal reform would be to disentangle the various components of the EITC program and to divide the program into its natural pieces. For example, a small part of the EITC benefit would fit comfortably within the tax system because it reduces income taxes otherwise due. Another part, intended to offset the taxpayer's payroll tax liability, could be provided more efficiently by means of a payroll tax exemption. Still another part, intended to provide additional income support for very poor workers who also receive welfare benefits, might be delivered through the welfare system. Finally, the portion of the benefit designed to subsidize children could be incorporated into

a per-child tax credit or an expanded dependency exemption.

E. Smaller changes to the design of the existing program.

Finally, let me offer the subcommittees four additional suggestions to improve compliance without a major redesign of the EITC program.

1. Probably the single best step Congress can take to curb noncompliance without a major change is to restrain the growth of the program and the amount of benefit provided. Under current law, the size of the benefit available from the program no longer bears any relationship to taxes owed by the person making the claim. Accordingly, given our self-assessment tax system, it is just too easy to file a fraudulent claim that is virtually undetectable by the IRS.

For example, by 1996, an individual with two or more qualifying children who reports \$8,000 in self-employment income would be entitled to an EITC benefit of 40 percent of that amount, or \$3,200. If that amount were reported, the individual would owe a self-employment tax of about \$1,200, but no income taxes. By reporting that income, therefore, the individual would receive a net cash benefit from the government of about \$2,000 (\$3,200 - \$1,200) plus Social Security retirement credit. There is therefore a strong incentive in certain cases to falsify the existence of income. ¹³

Could the IRS easily establish that the individual in fact earned less than

¹³See C. Eugene Steuerle, Two Problems with the New Earned Income Tax Credit, 48 Tax Notes 1691 (1990); C. Eugene Steuerle, The "Superterranean Economy," 51 Tax Notes 647 (1991); C. Eugene Steuerle, The IRS Cannot Control the New Superterranean Economy, 59 Tax Notes 1839 (1993).

the amount of income reported? No. The tax laws and administrative procedures are generally designed to ferret out income *under*statement cases, not the reverse situation of possible *over*statements of income. Information filing, for example, permits the IRS to verify that taxpayers do not omit items of income on their tax returns. But if taxpayers voluntarily report *more* income than their paper trail might suggest, there is little the IRS can do to detect an error in the absence of a full-scale audit.¹⁴

2. A second suggestion is to change the program so that the size of the EITC benefit is determined based on income amounts that can be easily verified by the IRS. For example, the benefit could be calculated, as under current law, as a percentage of earned income, but only earnings reported on a W-2 form would qualify. Further, the EITC award to a taxpayer might be delayed until the IRS receives a matching and verified copy of the W-2 from the employer. This rule would preclude a taxpayer from getting any EITC based on

¹⁴The concern about the potential overreporting of income may be more than just theoretical. In its final report of the 1993 tax year study, the IRS discovered an interesting "bubble": compared to all EITC claimants for the year, a higher percentage of those sampled (early electronic filers claiming the EITC) reported AGI in the \$10,000 to \$15,000 range. See Richardson Finance Committee statement, note 1, at Appendix, p.7. For 1993, the maximum credit was available to taxpayers with income between roughly \$8,000 and \$12,000. Thus, if one assumes that early electronic filers are more likely to be noncompliant than the general filing population, the bubble may reflect an effort by taxpayers to report income levels producing the maximum EITC benefit.

The IRS report also indicated that compared to all EITC claimants, a much smaller percentage of those sampled reported having any schedule C business income. Id. This statistic may simply evidence the inability of taxpayers with schedule C income to file returns very early in the filing season. From a noncompliance standpoint, it suggests that if the taxpayers sampled erroneously reported income in the maximum credit range, they may have utilized falsified W-2 forms to accomplish their objective.

self-employment income and various other forms of earned income, all items difficult for the IRS to verify, as well as earnings listed on a fabricated employee or employer W-2 form. This change would also simplify the process of claiming the credit for all taxpayers.

According to the GAO, the IRS does not currently have the computer capability to match employer-provided wage information with taxpayer-provided information prior to the normal processing of the taxpayer's return. Thus, this suggestion would result in some delay in the portion of a taxpayer's refund relating to the EITC. Delaying EITC payments is clearly undesirable, and every effort should be made to accelerate the IRS's matching capability. It should be borne in mind, however, that some part of the EITC population voluntarily chooses to delay their receipt of the benefit by electing not to obtain the credit through the advance payment option. Thus, a brief delay in benefit payments may not be as objectionable as first appears.

3. A third suggestion is to require as a condition of receiving the EITC that a taxpayer reside with a qualifying child for substantially all of the taxable year rather than for just more than half of the year. Under current law, the qualifying child requirement is the source of much confusion and potential

¹⁵See Willis statement, note 5, at 20.

¹⁶According to the GAO, despite many steps recently taken by the IRS to publicize and encourage the availability of the advance payment option, as of May 26, 1995, only about one percent of EITC recipients had reported using the option for tax year 1994. See Willis statement, note 5, at 19. No doubt, some significant percentage of those not using the option still are not aware of it, but its lack of use must also reflect some degree of taxpayer preference.

fraud. More than one taxpayer, or the wrong taxpayer, may try to claim a particular child, and some taxpayers even claim fictitious children. This change would do nothing to curb the claiming of fictitious children, but it would provide a more easily verifiable test, and would clear up some of the confusion arising in situations where a child lives in several different homes in the course of a year. Unless a child resided with the taxpayer for substantially all of the taxable year, no credit would be available to the taxpayer.

4. Finally, Congress ought to consider barring the claiming of the EITC on electronically filed tax returns. Just as a burglar is going to burglarize the most vulnerable house on the street, those of a criminal mind are constantly casing the soft spots in our federal tax and transfer system. Surely one of the most vulnerable points is the receipt of EITC money through an electronically filed return. The speed with which a fraudulent claim may be processed and awarded makes that transaction a particularly appealing one to criminals.

To be sure, the IRS has taken important steps during this filing season to curb fraud effected through electronic filing, and Congress should probably await an evaluation of the IRS's latest efforts before barring electronic EITC claims altogether. But there is no strong policy reason to expedite EITC claims, particularly if doing so makes the system more susceptible to fraud.

I recognize that the IRS, tax preparation services, and certain financial institutions may all object to a complete bar of electronically filed EITC claims. The short answer to those in the private sector is that they are not the intended

beneficiaries of the EITC program or of electronic filing. If their incidental benefits are limited by this change, so be it. As to the IRS, I think the burden is on them to establish sufficient control over the problem to justify the continued availability of electronic filing in this area.

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COAL INDUSTRY RETIREE HEALTH BENEFIT ACT OF 1992

HEARING

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT

OF THE

COMMITTEE ON WAYS AND MEANS HOUSE OF REPRESENTATIVES

ONE HUNDRED FOURTH CONGRESS

FIRST SESSION

JUNE 22, 1995

Serial 104-67

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COAL INDUSTRY RETIREE HEALTH BENEFIT ACT OF 1992

THURSDAY, JUNE 22, 1995

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON OVERSIGHT,
Washington, DC.

The Subcommittee met, pursuant to call, at 10 a.m., in room 1100, Longworth House Office Building, Hon. Nancy L. Johnson (Chairman of the Subcommittee) presiding.
[The advisory announcing the hearing follows:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

SUBCOMMITTEE ON OVERSIGHT

FOR IMMEDIATE RELEASE June 7, 1995 No. OV-9

Johnson Announces Oversight Hearing on

CONTACT: (202) 225-7601

Congresswoman Nancy L. Johnson (R-CT), Chairman of the Subcommittee on Oversight of the Committee on Ways and Means, today announced that the Subcommittee will hold a hearing to examine the operation of the Coal Industry Retiree Health Benefit Act of 1992. This legislation, which was enacted as part of the Energy Policy Act of 1992, related to funding the health benefits of retired coal miners. The hearing will take place on Thursday, June 22, 1995, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 10:00 a.m.

Coal Industry Retiree Health Benefit Act of 1992

This hearing will feature invited witnesses only. In view of the limited time available to hear witnesses, the Subcommittee will not be able to accommodate requests to testify other than from those who are invited. Those persons and organizations not scheduled for an oral appearance are welcome to submit written statements for the record of the hearing.

BACKGROUND:

The Coal Industry Retiree Health Benefit Act, which was enacted as part of the Energy Policy Act of 1992, established rules for the financing and provision of health benefits to retired mine workers who were members of the United Mine Workers of America (UMWA) and their families.

Prior to the Act, the UMWA and the Bituminous Coal Operators Association entered into a series of collectively bargained agreements to provide members of the UMWA with health and disability benefits. The trusts established to provide these benefits encountered financial difficulties. Of particular concern was the financing of benefits for so-called "orphan retirees" and related beneficiaries whose former employers were no longer in business or were no longer signatories to the collective bargaining agreement (the so-called "reachback companies").

To provide a more stable financing mechanism for coal miners' health and disability benefits, the Act created two new health benefit funds, established eligibility criteria, provided for the assignment of individual beneficiaries to specific companies that will be held responsible for paying premiums on their behalf, and created financing mechanisms. Under the Act, a company is charged an insurance premium based on the number of beneficiaries assigned to the company in its role as the retiree's "last signatory employer." Companies responsible for paying the designated premiums include any company that signed any National Bituminous Coal Wage Agreement since 1950 or any related company as defined under the Act. To cover costs associated with beneficiaries who cannot be assigned, for the first three years after enactment, up to \$70 million per year is transferred into the Combined Fund from the surplus in the UMWA 1950 Pension Fund. In addition, interest earnings of the Abandoned Mine Reclamation Fund are transferred into the Fund annually beginning on October 1, 1995. Costs for unassigned beneficiaries in excess of the transfers are allocated to the signatory and reachback companies in proportion to their share of assigned beneficiaries.

The retiree health benefits provisions originated in the Senate; there were no comparable provisions in the House bill. The provisions became effective October I. 1993.

FOCUS OF THE HEARING:

The hearing will examine: (1) the general effectiveness of the 1992 provisions; (2) the current and future financial status of the Combined Fund; (3) the impact of premiums on small producers and reachback companies; (4) the methods and procedures for collecting premiums and penalties; and (5) the commitment of Social Security Administration resources to calculating premiums, assigning beneficiaries to operators and considering appeals.

"The coal miner retiree health provisions of the 1992 Energy Act addressed a terribly complicated and contentious matter without any input from the House of Representatives," noted Chairman Johnson. "As part of the Ways and Means Committee's ongoing oversight responsibilities, it's time to take a look at whether these provisions are working as they were intended."

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Any person or organization wishing to submit a written statement for the printed record of the hearing should submit at least six (6) copies of their statement, with their address and date of hearing noted, by the close of business Friday, July 7, 1995, to Phillip D. Moseley, Chief of Staff, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements wish to have their statements distributed to the press and interested public at the hearing, they may deliver 200 additional copies for this purpose to the Subcommittee on Oversight office, room 1136 Longworth House Office Building, at least one hour before the hearing begins.

FORMATTING REQUIREMENTS:

Each enterence presented for pensing to the Committees by a witness, any writess attenuent or exhibit substituted for the printed record or any writtee communits in response to a request for writine communit mante confirms to the graduations intend below. Any statement or exhibit not in compliance with these graduations will not be printed, but will be maintained in the Committee Size for review and nos by the

- All statements and any necesspanying exhibits for printing must be typed to single space on legal-size paper and may not exceed a total of 10 pages including attachments.
- Copies of whole decements submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraghraped. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.
- A winness appearing at a public booring, or relumining a statement for the record of a public bearing, or redunining written comments in response to a published reposes for comments by the Committee, must include on his statement or redunining at life of all clients, persons, or organizations on whose bolaid the witness appears.
- 4. A supplemental short most accompany each statement listing the name, full address, a telephone number where the witness or the designated representative may be reached and a napical settless or amounts of the numerous and recompanyisations in the full statement. This negationness flowled will not be included in the principle record.

The above restrictions and finitedness apply only to material being ordented for printing. Statements and exhibits or outplementary material submitted solely for distribution to the Hembers, the press and the public during the ocurse of a public bearing may be estimated in other forms.

Note: All Committee advisories and news releases are now available over the Internet at 'GOPHER.HOUSE.GOV' under 'HOUSE COMMITTEE INFORMATION'.

Chairman JOHNSON. I would like to call the hearing to order.

My Ranking Member will be along soon, but I must excuse myself briefly shortly to testify on the Superfund issue before another Committee, so I would like to start this morning promptly and make a few comments. Then, I will yield the chair to my colleague, Mr. Hancock.

Someone once said that an elephant is a mouse built to government specifications, and it might be said that this morning we are here to examine such a mouse. The Coal Industry Retiree Health Benefits Act of 1992 addressed a legitimate concern about the solvency of the UMWA, United Mine Workers of America, 1950 and 1974 health benefit funds and the ability of those funds to provide benefits for retired coal industry workers and their eligible dependents.

It is less clear whether Federal Government intervention on the order provided under the coal act was an appropriate response. You will recall that it did not get the usual legislative consideration.

I have been trying to think of another instance in which private sector retiree benefits have been negotiated under a collective bargaining agreement, with responsibility for calculating premiums, assigning beneficiaries to specific employers, and considering

appeals delegated to the SSA.

I have also been trying to think of another instance in which private sector retiree benefits, negotiated under a collective bargaining agreement, are financed by premiums that are subject to enforcement by the Treasury. I am deeply troubled by the thought that as other employers have difficulty in funding retiree health benefits in the future, public policymakers might turn to the 1992 statute as a model.

Like the story of the "Blind Men and the Elephant," each interest comes to this issue with its own interpretation of reality and, in

many cases, even with its own facts.

We have been told that the 1992 statute is the only way to provide fairness to the BCOA, Bituminous Coal Operators' Association, Inc., companies. We have been told that we should provide relief only to the super-reach-back companies, that there should be a carve-out for small companies or hardship cases, and that such a carve-out overlooks inequities faced by larger, profitable companies.

We have also been told that the Combined Benefit Fund is in surplus and is likely to remain so, that the surplus is an anomaly

that will soon disappear.

I am not so naive as to believe that we will resolve all of these disagreements today, but it is time to take a look at how the statute is functioning and to establish a factual foundation for considering whether revisions are needed.

It is our intent that every point of view will be heard today. That

will take some time.

Welcome. The opening witnesses are at the table.

Mr. Thornton, the Deputy Tax Legislative Counsel for the Department of Treasury, we will start with you, and my apologies for having to be gone.

Before you proceed, there are other Members of the panel who

would like to make a statement.

Mr. Hancock.

Mr. HANCOCK [presiding]. Thank you, Madam Chairman.

We will go through this quickly. We have a vote on.

I commend you for holding this hearing today. It is about time we got to the bottom of some of the issues surrounding the coal act of 1992 and the retroactive tax which has been imposed on companies that have been out of the bituminous coal business for decades.

I will say at the outset, I have no constituent interest in this issue. I just believe that the coal act sets a bad precedent and

represents bad policy judgment by the Congress.

Perhaps if Congress had properly considered the legislation, reason would have prevailed. Instead, the coal act was added to the Energy Policy Act in conference without prior consideration by the Ways and Means or Finance Committees. Had this issue been properly considered, I am sure that many Members of Congress would have had major concerns over the precedent set by this Act.

I was among only 60 Members of the House who voted against the energy act. Now as I look back at it, that may have been the

best "No" vote I ever cast.

Make no mistake about it, the coal act is nothing more than a Congressional bailout of a union benefit plan orchestrated by the Mine Workers Union and those companies which remain in the bituminous coal business. By imposing this tax, which is paid into a private health care plan, Congress has become the ultimate and final arbiter in what was an ongoing collective bargaining process.

Let me remind everyone how we got into this situation. The union and the BCOA, which is comprised of a dozen or so large companies which still mine bituminous coal, got together and formed a coalition 4 years ago to pursue alternative means, including legislation, of solving a health care problem they claimed they could not resolve through normal collective bargaining channels. The BCOA companies pumped almost \$3 million into the Coalition and the union contributed about \$100,000, but also devoted considerable manpower, material and other resources to the effort.

Let me read just one paragraph from a memorandum the Legislative Director sent to the president of the union in April

1991.

Creating the atmosphere of crisis is obviously important to our strategy. Getting Congress to act is always difficult in the absence of a pressing need. We are treading a fine line in creating a crisis among the pensioners that can be controlled by us. Using the threat of a strike will be necessary to galvanize interest, but the reality of a strike or a cutoff of benefits creates their own set of problems.

So, the Coalition pushed legislation that used a pension fund surplus, a transfer from the Abandoned Mine Lands Reclamation Fund and reached back to 1950 to impose retroactive taxes on almost 700 businesses.

Was there truly a crisis?

When you look at the status of the health benefit fund today, you see a totally different picture. Not only has every health benefit claim been paid in full and no retiree or dependent been denied a claim due to lack of funds, the UMWA Combined Benefit Fund holds an enormous surplus.

If there was ever any real crisis at all, it was caused by the BCOA's 1988 change in the way health benefit contributions to the

1950 fund were calculated. By changing their funding calculation from a "per-ton" to a "per-hour" contribution method, the BCOA drastically reduced the amount of money they were paying for retiree health benefits. Because tonnage production remained constant and hourly productivity increased, this change saved BCOA

companies enormous sums.

Of course, by spreading the cost of these health benefits around to reach-back companies under the coal act, the BCOA companies saved even more. By their own admission, these businesses figure to save \$125 million per year between 1993 and 2043. As we listen today to witnesses who say that any change in the coal act will jeopardize a delicate compromise, I hope you question whose interest is served in maintaining the status quo.

Not only have the reach-back companies had to foot the bill for this Act, vast taxpayer resources are being expended to implement it. To start with, the taxpayers gave the Social Security Administration \$10 million to assign retirees to the reach-back companies. That money is long gone, but the cash register is still running at

SSA.

It is troubling to imagine how much taxpayer money the Departments of Health and Human Services, Labor, Treasury, Justice and others have spent to interject the Federal Government into a private insurance program. In addition to these costs, the Treasury has lost millions in revenue because the money sent to the union for these health care premiums became fully deductible under the act.

John Myers and I have introduced legislation to correct this mess without jeopardizing any benefits enjoyed by those covered by the fund. Twenty Members of the Ways and Means Committee and the Majority Leader in the House have signed on as original

cosponsors.

Clearly, some changes will occur in this Act. I consider our bill a compromise between the status quo and outright repeal of the coal act. However, I want to make it clear that I will consider any option that permanently eliminates the onerous retroactive tax that has been placed on the backs of reach-back companies. Since I am Acting Chairman right now, I do not guess I need to thank the chairman. But we are looking forward to the testimony and we are going to recess now to go vote and we will be right back.

Thank you.
[Recess.]

Mr. HERGER [presiding]. We will reconvene the Subcommittee on

Oversight, Committee on Ways and Means.

If our first witness on our panel, Michael Thornton, Deputy Tax Legislative Counsel for the U.S. Department of Treasury will proceed, please.

STATEMENT OF MICHAEL B. THORNTON, DEPUTY TAX LEGISLATIVE COUNSEL, U.S. DEPARTMENT OF TREASURY

Mr. THORNTON. Thank you.

Mr. Chairman and distinguished Members of the Subcommittee, I am pleased this morning to present the views of the Treasury Department regarding the Coal Industry Retiree Health Benefit

Act of 1992, which I will refer to as the coal act.

The coal act was enacted as part of the Energy Policy Act of 1992. Its goal was to ensure adequate funding of health benefits for retired miners and their families. In 1993, this administration testified before the Committee on Ways and Means in strong support of the goals of this Act. We continue to strongly support those goals.

The Subcommittee has asked us to address several specific issues regarding the coal act: Its general effectiveness, its impact on certain companies, and the procedures for collecting premiums and

penalties.

The coal act appears to have been effective in ensuring that benefits that were promised to retired union miners and their families

continue to be paid without interruption.

We understand that currently the combined fund is in sound financial condition, although its future financial status is unclear. According to recent analysis by the GAO, the combined fund reported a surplus of about \$115 million as of September 30, 1994. However, GAO has stated that future annual surpluses may not occur and annual deficits may erode the current surplus over time. Given this uncertain financial outlook, the administration would be troubled by any modifications to the coal act that would diminish the fund's security.

Finally, the coal act appears to have been effective in ensuring collection of the required premiums, with about 91 percent of the assessed premiums having been collected by the combined fund.

It is difficult if not impossible to isolate the effects of the coal act on the coal industry as a whole or on certain categories of companies within the coal industry. Factors independent of the coal act have reduced the number of mines and mining companies. These factors include major changes in the coal industry, such as a shift to western coal and declining real coal prices. We are aware that concerns have been expressed the coal act may have contributed to financial hardship for certain small companies. However, the administration is concerned that legislative proposals that would provide relief based solely on size or reach-back status could benefit some companies that are not actually experiencing hardship, weaken the combined fund and threaten the health benefits of the retirees and their families.

Responsibilities for administering the combined fund are divided among three entities: the combined fund itself, which is a private nongovernmental multi-employer benefit plan, the SSA, and IRS.

The trustees of the combined fund are responsible for collecting the premiums based on information supplied to them by the SSA. The trustees are restricted by fiduciary duty to the fund from waiving collection of premiums. However, to maximize the fund's return, the trustees may take collection and litigation risk into account in resolving delinquent accounts.

The IRS is not responsible for collecting the premiums, but is responsible for assessing any penalties for noncompliance. The penalty for failure to pay a required premium is \$100 per day per beneficiary. Under current law, IRS is limited in its ability to waive the penalty. The situation has not yet created problems because the IRS so far has not assessed the penalty. In its testimony this morning, the IRS will address this matter in detail.

We are concerned that the \$100 per-day penalty may be excessive. The first month's penalty alone would exceed the annual premium. As a general policy matter, this level of penalty raises questions in light of the relative level of premiums to which the penalty applies. A revised penalty structure might in certain circumstances provide a better enforcement tool.

If the current penalty structure is retained, it may be desirable to consider limiting the penalty or granting the IRS additional

discretion to waive or reduce the penalty in certain cases.

We are willing to work with the Subcommittee to address this and other concerns in a manner that preserves the security of the fund and guarantees that health benefits for retired miners and their families will not be interrupted.

This concludes my prepared remarks. I will be happy to answer any questions. [The prepared statement follows]:

STATEMENT OF MICHAEL B. THORNTON DEPUTY TAX LEGISLATIVE COUNSEL (TAX LEGISLATION) DEPARTMENT OF THE TREASURY BEFORE THE

SUBCOMMITTEE ON OVERSIGHT COMMITTEE ON WAYS AND MEANS UNITED STATES HOUSE OF REPRESENTATIVES

Madame Chair and distinguished Members of the Subcommittee:

I am pleased to present the views of the Treasury Department on the Coal Industry Retiree Health Benefit Act of 1992 ("the Coal Act"), which was enacted as part of the Energy Policy Act of 1992, P.L. 102-486. In the letter of invitation, Chairman Johnson has requested that our testimony address: (1) the general effectiveness of the 1992 provisions; (2) the impact of premiums on small and reachback companies; (3) the methods and procedures for collecting premiums and penalties; and (4) whether Treasury has perceived a need to exercise discretion in enforcing premium collection because of the potential impact on some operators.

In testifying before the Committee on Ways and Means in September 1993, the Administration expressed its strong support for the goal under the Coal Act of ensuring adequate funding of retired miners' health benefits. We continue to strongly support this goal.

Background

The Coal Act requires that former employers of retired coal miners finance, in part, the health benefits that previously were negotiated for those miners and their families by the United Mine Workers of America ("UMWA"). Prior to the Coal Act, these benefits were provided for retired miners and their families either by the miner's individual employer or through one of two multiemployer funds -- the 1950 UMWA Health Benefit Fund (the "1950 Fund") or the 1974 UMWA Health Benefit Fund (the "1974 Fund"). Contributions to both Funds were required of signatories to the national wage agreements negotiated between the UMWA and the Bituminous Coal Operators Association, Inc. ("BCOA").
Employers that were not signatories to the national wage agreement also contributed to the Funds under separate wage agreements negotiated with the UMWA.

The 1950 Fund covered miners who had retired as of December 31, 1975, and their beneficiaries. Miners who retired after 1975 generally received health benefits under the single plan of their former employer. However, if the employer went out of business or left the coal industry, the employer's retirees and their beneficiaries were covered by the 1974 Fund. As a result, all of the retirees and their beneficiaries covered under the 1974 Fund were "orphans" for whom no contributions were being made by their former employers. About half of the retirees and their beneficiaries in the 1950 Fund were orphans.

Beginning in the late 1980's, the Funds began to experience serious financial difficulties. As of March 31, 1992, the combined deficit of the Funds reached \$140 million and was projected to grow dramatically if no changes were made. The deficit was precipitated by a number of factors, including medical inflation and the trustees' inability to impose certain kinds of containment mechanisms under the Funds. Moreover, the contribution base of the Funds was eroding. In the early 1980's, for example, approximately 2,000 employers contributed to the Funds. That number had fallen to about 300 in 1992.

In March 1990, as part of a compromise that helped settle the Pittston Coal Company strike, then-Secretary of Labor Elizabeth Dole announced the establishment of a special national Coal Commission to study the Funds. In its report, published in November 1990, the Coal Commission agreed that the problems of the Funds could not be solved through private bargaining alone. The Coal Commission recommended establishing a statutory obligation to contribute to the Funds. Although the Coal Commission was divided as to how this obligation should be implemented, there was general agreement that it should cover all then-current signatory employers (companies that had signed the 1988 collective bargaining agreement), as well as certain other signatory employers.

In response to the Coal Commission Report and growing concerns about the continued viability of the Funds and the security of retirees' benefits, Congress passed the Coal Act as part of the Energy Policy Act of 1992.

The Coal Act created two new benefit funds: (1) the UMWA Combined Benefit Fund (the "Combined Fund"), which services beneficiaries receiving health benefits from the 1950 and 1974 Funds as of July 20, 1992; and (2) the UMWA 1992 Benefit Plan (the "1992 Plan"), which services certain employees who retired between July 20, 1992, and September 30, 1994, and whose last signatory employer is not providing them with benefits.

Employees retiring after September 30, 1994, are not covered under the provisions of the Coal Act, but are dependent on the provisions of future bargaining agreements.

Under the Coal Act, any employer that signed a wage agreement with the UMWA since 1950 and has retirees who benefit under the Funds could be obligated to pay premiums for the health benefits of those retirees and their beneficiaries. In addition, employers are obligated to finance the health benefits of "orphans" in the Combined Fund whose former employers are no longer in business. Each employer's share of orphans is proportional to the number of the employer's retirees who receive health benefits under the Combined Fund. Generally, the allocation method assures that costs are shared by all employers that signed UMWA wage agreements providing for retiree health benefits.

In order to reduce premiums associated with orphan beneficiaries who could not be assigned to a particular employer, the Coal Act authorized three annual transfers of \$70 million each from the excess assets of the UMWA 1950 pension plan. Beginning October 1, 1995, annual transfers of up to \$70 million will come from the interest earnings of the Abandoned Mine Land Reclamation Fund ("AML fund") to cover the costs of orphans. The AML fund is financed by fees assessed on all coal mining companies.

Because beneficiaries were not yet assigned to signatory operators during the first plan year of the Combined Fund, 3 transition rules provided for the 1988 signatories to make contributions to the Combined Fund to finance benefits and administration costs that were not covered by the \$70 million transferred from the 1950 Pension Fund. The 1988 signatories receive a credit for these initial contributions against

To the extent that interest earned on the AML fund falls short of \$70 million in any year, the difference is made up out of the interest accumulated during the FY 1993-95 period (about \$122 million). In FY 1996, interest earnings on the AML fund are expected to be about \$57 million.

The Abandoned Mine Reclamation Fees are levied at the lesser of (a) 35 cents per ton for surface-mined coal and 15 cents per ton for underground-mined coal, or (b) 10 percent of the value of the coal at the mine. For lignite, the rate is the lesser of 10 cents per ton, or 2 percent of the value of the coal at the mine.

The first plan year was a short one, running from February 1, 1993, to September 30, 1993.

subsequent premiums. The 1988 signatories also were required to make transition payments to cover the combined net deficits held by the merged 1950 and 1974 Benefit Plans.

Under the Coal Act, responsibilities for administering the Combined Fund are divided among three separate entities, as described below:

- (i) The Social Security Administration (SSA) -- The SSA is responsible for assigning each coal industry retiree receiving benefits to a former employer or related party. The SSA also calculates the annual per-beneficiary premium charged to each former employer. Following the assignment of beneficiaries to employers, the SSA is responsible for informing the former employer and the trustees of the Combined Fund of the assignments. Finally, the SSA is responsible for reviewing appeals raised by employers regarding the assignments of retirees, and reassigning the retirees when appropriate.
- (ii) Trustees of the Combined Fund -- As established by the Coal Act under section 9702 of the Internal Revenue Code, the Combined Fund is a private multi-employer plan. The Coal Act provided for a Board of Trustees' who were required, among other duties, to establish the Combined Fund, to determine benefits to be paid from the Combined Fund, to establish and maintain accounts of the premiums that are required to be paid to the Combined Fund, to collect the premiums, and to provide information to the SSA, as necessary for carrying out the SSA's duties under the Coal Act.
- (iii) Department of the Treasury -- Section 9707 of the Internal Revenue Code imposes a penalty upon an assigned operator for failure to pay a required premium. The statute treats the penalty as an internal revenue tax, and thus the IRS, as part of its general tax administration duties, is responsible for collecting the penalty.

Discussion

1. The Effectiveness of the 1992 Provisions

The principal goal of the 1992 provisions was to ensure that benefits promised to retired union miners and their families continue to be paid without interruption. The 1992 provisions appear to have been effective in achieving this goal.

The Combined Fund appears to be in sound financial condition currently, although its future financial status is unclear. According to recent GAO analysis, the Combined Fund reported a surplus of \$114.8 million as of September 30, 1994, but future annual surpluses may not occur, and annual deficits may erode the current surplus over time. Given this uncertain financial outlook, the Administration would be troubled by any modifications to the Coal Act that would diminish the security of the Fund.

⁴ The provisions for the 1992 Fund were not developed in as much detail. Responsibility was given to the settlors (the UMWA and BCOA) to work out many of the specific provisions.

³ The Coal Act provides that the Combined Fund is a plan described in section 302(c)(5) of the Labor Management Relations Act of 1947 (LMRA), an employee welfare benefit plan within the meaning of section 3(1) of the Employee Retirement Income Security Act of 1974 (ERISA), and a mulitemployer plan within the meaning of section 3(37) of ERISA. Both LMRA and ERISA are administered by agencies in the U.S. Department of Labor.

Section 9702(b) of the Internal Revenue Code provides for the appointment of a board of seven trustees. One trustee is designated by the BCOA to represent employers in the coal mining industry; one trustee is designated by the three reachback companies with the greatest number of eligible employees; and two trustees are designated by the UMWA. These four trustees select the other three.

It appears that the Coal Act also has been effective in ensuring collection of the required premiums. According to representatives of the Combined Fund, approximately 91 percent of the assessed premiums have been paid.

While it appears that the Coal Act has been effective to date, we are aware that concerns about its operation and effectiveness persist. We would be happy to work with the Subcommittee to address such concerns in a manner that will not compromise the security of the funds or otherwise risk interrupting health benefits for retired miners and their beneficiaries.

2. Impact of the Premiums

It is difficult, if not impossible, to isolate the effects of the Coal Act on the coal industry as a whole or on certain categories of companies within the coal industry. The health of the coal-mining industry primarily reflects dynamic factors that are largely independent of the impact of the premiums -- factors such as productivity improvements, price changes and structural shifts.

The coal industry has seen substantial growth in consumption and productivity in recent years. This growth has been accompanied by a shift to western coal, largely due to the higher productivity of long-wall mining and western coal's lower sulphur content. Lower-cost western coal and improved productivity have resulted in declining real coal prices since the mid-1970's.

Technological improvements in mining operations and a shift away from underground mining in the East to less labor-intensive surface mining in the West allowed labor productivity to increase much more rapidly than for most other U.S. industries. Over the period from 1980 to 1992, output per hour of work in coal mining increased at an average rate of 6.65 percent, whereas output per hour of work in all forms of nonfarm business increased at an average annual rate of 1.16 percent. The number of production workers in coal mining fell from 204,000 in 1980 to 101,000 in 1992, while production increased from 830 million tons in 1980 to 998 million tons in 1992. These changes also involved a reduction in the number of operating mines and mining companies. Improvement in mining productivity has placed financial pressure on eastern mines that have not managed sufficient productivity increases.

We are aware that concerns have been expressed that provisions of the Coal Act may have contributed to financial hardship for certain small companies. Legislative proposals have been introduced to provide relief under the Coal Act. The Administration would be concerned, however, about proposals that provide relief without reference to specific financial hardship. These types of proposals could unnecessarily exacerbate the burden of financing retirement health benefits, by imposing an even greater burden on other companies that are not eligible for the relief, but that might be in worse financial condition. In particular, any relief provisions based solely on a company's size or status as a reachback company, which does not necessarily reflect its financial condition, could weaken the Combined Fund and threaten the benefits of the retirees and their families.

According to representatives of the Combined Fund, its collection program is designed to resolve all the delinquencies, either through collection or uncollectibility determinations, after weighing the time and expense involved in the investigations and the likelihood of successful recovery.

3. Methods and Procedures for Collecting Premiums and Penalties

As noted above, premiums under the Coal Act are assessed and collected through the efforts of the trustees of the Combined Fund, based on assignments made by the Social Security Administration. In addition, the Coal Act imposes a penalty for delinquent premium payments. Pursuant to the Coal Act, this penalty is treated in the same manner as an internal revenue tax. Consequently, the Internal Revenue Service, as part of its general authority to assess and collect taxes and penalties, has jurisdiction over the collection of the penalty.

Because operators have the ability to appeal the assignment by the SSA, reliable information regarding liability for premiums currently is not immediately available following the annual billing. In addition, assessment of the penalty prior to collection action with respect to the premiums by the Combined Fund would reduce funds available for providing benefits to retired miners and their families. Moreover, in some cases the resources required for collecting the penalties may exceed the reasonable expectations of collection, given the financial condition of an operator.

Because it would be premature to attempt to assess penalties before the completion of collection efforts by the Combined Fund, the IRS has not assessed penalties to date. However, representatives of the IRS have met with the Combined Fund regarding the coordination of their collection efforts with the implementation of the penalty. In its testimony this morning, the IRS will address these matters in detail.

4. Exercise of Discretion in Enforcing Premium and Penalty Collection

The trustees of the Combined Fund are responsible for collecting premiums, and they are restricted by their fiduciary duty to the fund from waiving collection of premiums. To maximize the return to the fund, it appears that the trustees could take collection and litigation risks into consideration, as well as the fact that any penalties collected by the IRS would be paid to the government rather than to the Combined Fund.

The IRS is responsible for assessing any penalties for noncompliance. The Coal Act provides for two types of penalties for failure to make required contributions:

(i) Penalty for Delinquent Contributions of Transition-Year Payments. As described above, the Coal Act required 1988 signatory employers to make initial contributions for the Combined Fund's first short year (February 1, 1993, to September 30, 1993). Under section 9704(i)(1)(C) of the Internal Revenue Code, the penalty for failure to make these initial contributions is nondeductibility of contributions to the Combined Fund, until such time as the failure is corrected. No discretion is provided to waive this penalty, nor would any such discretion appear necessary or appropriate, since the penalty terminates once the taxpayer makes the required contribution.

Under section 9706(f)(5) of the Internal Revenue Code, an assigned operator is required to pay premiums pending review by the SSA. If the retirees are reassigned, the operator is allowed a credit against premiums for other retirees.

Penalties for nonpayment of premiums are paid to the government rather than the Combined Fund.

(ii) Penalty for Delinquent Premium Payments. The penalty for failure to pay a required premium is \$100 per day per beneficiary, for the period commencing on the due date for the required premium or installment, and ending on the date of payment of the premium or installment. The penalty is not imposed if it is established to the satisfaction of the Secretary of the Treasury that none of the persons responsible for the failure knew, or exercising due diligence, would have known that the failure existed. In addition, the penalty is not imposed if the failure was due to reasonable cause and not to willful neglect and the failure is corrected within 30 days after any of the persons responsible for the failure knew or should have known that the failure existed. Moreover, if the failure is due to reasonable cause and not to willful neglect, the Secretary of the Treasury has authority to waive all or part of the penalty to the extent that he determines that payment of the penalty would be excessive relative to the failure involved.

Under these provisions, the Treasury Department is limited in its ability to waive the penalty for delinquent premiums. In particular, this standard for relief generally does not allow for the waiver of penalties for nonpayment based solely on the financial hardship of the taxpayer.

Because, as noted above, the IRS has not yet attempted to assess the penalty for delinquent premiums, the IRS's limited ability to waive the penalty has not yet created problems.

Nonetheless, we are concerned that the \$100 per-day, perbeneficiary penalty for delinquent premiums may be excessive. The first month's penalty alone (from \$2800 to \$3100) would exceed the annual premium (about \$2350 for FY 1995).

As a general policy matter, this level of penalty raises questions in light of the relative level of premiums to which the penalty applies. Moreover, collection of the penalty may act at cross purposes to the goals of the Coal Act. Enforcing the penalty could adversely affect certain taxpayers' financial conditions, which in turn could jeopardize the payment of future premiums and result in reduced contributions to the Combined Fund, contrary to the goals of the Coal Act.

For these reasons, a revised penalty structure may, in certain instances, provide a better enforcement tool. In this regard, if the current penalty structure is retained, it may be desirable to consider granting additional discretion to the Secretary of the Treasury to waive or reduce the penalty for delinquent premiums in certain cases. In addition, we would be willing to work with the Congress to explore means of restructuring the penalty provision to limit the aggregate penalty while still providing an adequate incentive for prompt payment of premiums.

Conclusion

The Administration believes that the Coal Act has been effective in achieving its goal of ensuring uninterrupted health benefits for retired union miners. We continue to believe that the Coal Act was a reasonable solution to a difficult problem.

With respect to the enforcement provisions, we recognize that under current law the penalty for delinquent premiums may, in certain circumstances, become excessive relative to the required premium. We are willing to work with the Congress to address this and other concerns in a manner that would preserve the security of the Fund and the uninterrupted provision of health benefits to retired miners and their families.

The IRS has general authority to compromise a full tax liability, including interest and penalties, through an offer in compromise, where it is determined that the tax is uncollectible and the offer in compromise is in the best interests of both the taxpayer and the government.

Mr. HERGER. Thank you, Mr. Thornton. Phil Brand, Chief Compliance Officer, IRS.

STATEMENT OF PHIL BRAND, CHIEF COMPLIANCE OFFICER. INTERNAL REVENUE SERVICE

Mr. Brand. Mr. Chairman and distinguished Members of the Subcommittee, I appreciate the opportunity to appear before the Subcommittee today to discuss IRS' participation in administration of the Coal Industry Retiree Health Benefit Act of 1992.

The coal act was enacted as part of the Energy Policy Act of 1992, and it establishes a method for funding health and death benefits for retired coal miners, their spouses and dependents. The act establishes a scheme for funding benefits by assigning retirees to operators and requiring premium payments based on the number of retirees assigned. The SSA is responsible for assigning retirees to operators and calculation of the per beneficiary premium. Trustees of the combined fund are responsible for assessing and collecting the premiums. IRS' role is to impose sanctions for failure to make required payments to the fund.

Payments required of operators during the transitional year, February 1, to September 30, 1993, are called contributions. Payments required after the transitional year are called premiums. The act imposes one sanction if a required contribution is not

made, and another if a required premium is not paid.

Penalties are one important tool in administering the tax law. IRS' policy with respect to penalty administration is that penalties should be used to encourage voluntary compliance. Even though other results such as raising revenue or reimbursements of the cost of enforcement may also arise when penalties are assessed, the IRS will design and administer penalty programs solely on the basis of whether they do the best possible job of encouraging compliant behavior.

Since the IRS is not involved in determining and/or collecting the required payments, our responsibility then is to administer the sanctions in a manner that will foster voluntary compliance with the act. Based on information obtained from representatives of the combined fund, it is our understanding that compliance with the act is very high. We believe that approximately 91 percent of the assessed premiums are collected. Furthermore, of the amounts that have not been collected, almost half is either subject to of escrow agreements with operators contesting the constitutionality of the act, or is attributable to operators known to be the subject of bankruptcy proceedings. The remaining uncollected premiums are spread among small or insolvent or defunct operators who have been determined not to be collectible by the combined fund.

Operators who fail to make the required contributions during the transitional year are not allowed a deduction for all such contributions, or other contributions allowable under section 404(c) of the IRS Code on their income tax return until the delinquency is corrected; operators who fail to pay premiums timely are subject to a penalty of \$100 per day per beneficiary for each day after the due date until the premium is paid.

IRS then is responsible for ensuring that the deduction is not allowed for delinquent contribution payments. In addition, we are responsible for assessing and collecting the penalty for delinquent

premium payments.

Since the IRS is not involved in determining and collecting the required payments, sanctions can only be imposed when we are aware of whose is delinquent, the amount of the delinquency and the type of payment that is delinquent, a contribution or a premium.

To impose the deduction disallowance sanction, the IRS needs the following information; the identity of the delinquent operators, the amount of the required contribution, and the time when the

required contribution is paid in full.

Based on discussions with the combined fund, as to the potential liability of operators being reversed by appeal to the SSA, we have determined that the most efficient use of our enforcement resources is to obtain the needed information on delinquent contributions

through referrals from the combined fund.

In August 1993, the trustees of the combined fund sent the IRS a list of delinquent operators and requested IRS to enforce the deduction disallowance sanction. However, after consultation with IRS counsel, we determined that enforcement was premature since few if any of the operators would have filed their tax returns covering any part of the transactional planned year. Thus, action was delayed until the actual filing of the tax returns.

These returns are now due and presumably have been filed. Since we are now selecting business returns for 1993 for audit, we will use a requested update of the August 1993 list to inspect the tax returns and determine if a examination is warranted for the

contribution deduction.

When the premium payment is delinquent, the IRS needs the following information to enforce the penalty sanctions: The identity of the delinquent operators; the number of beneficiaries associated with the delinquent premium; the number of days the premium is delinquent for each beneficiary; and the time when the required

premium is paid in full.

As mentioned earlier in my testimony, information from the combined fund indicates that 91 percent of the assessed premiums have been paid. The fund has also indicated that proofs of claim, settlement negotiation suits and other actions are pending for 95 percent of the uncollected premiums. Taking into consideration the high level of compliance and that actions are under way to collect 95 percent of the uncollected premiums, the IRS has decided the most judicious use of our enforcement resources would be to focus on those operators referred to us by the combined fund. We are working closely with the fund. To date no referrals have been received, and thus no penalties have been assessed.

In conclusion, our policy is that penalties should be used to foster voluntary compliance. It would not benefit the fund, the beneficiaries, or the IRS to indiscriminately assess penalties against

companies that are financially unable to pay the premiums.

This concludes my prepared remarks.

I would be happy to answer any questions you or other Subcommittee Members may have.

[The prepared statement follows:]

STATEMENT OF PHIL BRAND CHIEF COMPLIANCE OFFICER BEFORE

SUBCOMMITTEE ON OVERSIGHT HOUSE COMMITTEE ON WAYS AND MEANS

JUNE 22, 1995

Madame Chairman and Distinguished Members of the Subcommittee:

I appreciate the opportunity to appear before this Subcommittee today to discuss IRS' participation in the administration of the Coal Industry Retiree Health Benefit Act of 1992 (Coal Act).

Background

The Coal Act was enacted as part of the Energy Policy Act of 1992. The Coal Act establishes a method for funding health and death benefits for retired coal miners and their spouses and dependents. Three organizations have responsibilities for administering the provisions of this Act — Social Security Administration, trustees of the Combined Fund, and the IRS.

The Act established a scheme for funding benefits by assigning retirees to operators and requiring premium payments based on the number of retirees assigned. The Social Security Administration is responsible for assigning retirees to operators and calculation of the per-beneficiary premium. Trustees of the Combined Fund are responsible for assessing and collecting the premiums. IRS' sole responsibility is to impose sanctions for failure to make required payments to the

Payments required of the operators during the transitional year (February 1, 1993 to September 30, 1993) are called contributions. Payments required after the transitional year are called premiums. The Act imposes one sanction if a required contribution is not made, and another if a required premium is not made. IRS Responsibilities

Penalties are one important tool in administering the tax law. IRS' policy with respect to penalty administration is that penalties should be used to encourage voluntary compliance. Even though other results, such as raising revenue, punishment, or reimbursement of the costs of enforcement may also arise when penalties are assessed, the IRS will design and administer penalty programs solely on the basis of whether they do the best possible job of encouraging compliant behavior.

Since the IRS is not involved in determining and/or collecting the required payments, our responsibility is to administer the sanctions in a manner that will foster voluntary compliance with the Act. Based on information obtained from representatives of the Combined Fund, it is our understanding that compliance with the Act is very high. We have been informed that approximately 91% of the assessed premiums are collected. Furthermore, of the amounts that have not been collected, almost half is either the subject of escrow agreements with operators contesting the constitutionality of the Act or is attributable to operators known to be the subject of bankruptcy proceedings. The remaining uncollected premiums are spread among small insolvent or defunct operators and have been determined to be not collectible by the Combined Fund.

Sanctions

Operators who fail to make required contributions during the transitional plan year are not allowed a deduction for all such contributions (or other deductions allowable under section 404(c) of the Internal Revenue Code) on their income tax return until the delinquency is corrected. Operators who fail to pay premiums timely are subject to a penalty of \$100 per day per beneficiary for each day after the due date until the premium is paid.

IRS, then, is responsible for ensuring that the deduction is not allowed for delinquent contribution payments until the delinquency is collected. In addition, IRS is responsible for assessing and collecting the penalty for delinquent premium payments.

Since the IRS is not involved in determining and collecting the required payments, sanctions can only be imposed when we are aware of who is delinquent, the amount of the delinquency, and the type of payment that is delinquent — a contribution or a premium.

Delinquent Contributions

To impose the deduction disallowance sanction, the IRS needs the following information:

- the identity of the delinquent operators.
- the amount of the required contribution, and
- the time when the required contribution is paid in full.

Based on discussions with representatives from the Combined Fund [as to the potential liability of operators being reversed by appeal to the Social Security Administration], we have determined that the most efficient use of our enforcement resources would be to obtain the needed information on delinquent contributions through referrals from the Combined Fund.

In August 1993, the trustees of the Combined Fund sent the IRS a list of delinquent operators and requested that IRS enforce the deduction disallowance sanction. However, after consultation with IRS Counsel, we determined that enforcement was premature since few if any of the operators would have filed their tax returns covering any part of the transitional plan year. Thus, action was delayed until the actual filing of the tax returns.

These returns are now due and presumably have been filed. Since we are now selecting business returns filed for tax year 1993 for audit, we will use a requested update of the August 1993 list of delinquent contributors to inspect the tax returns and determine if an examination is warranted for the contribution deduction. Delinquent Premiums

When the premium payment is delinquent, the IRS needs the following information to enforce the penalty sanctions of the Act.

- the identity of the delinquent operators.
- the number of beneficiaries associated with the delinquent premium,
- the number of days that the premium is delinquent for each beneficiary,
- the time when the required premium is paid in full.

As I mentioned earlier in my testimony, information from the Combined Fund indicates that 91% of the assessed premiums have been paid. The Fund has also indicated that proofs of claim, settlement negotiations, suits or other actions are pending for 95% of the uncollected premiums. Taking into consideration the high level of compliance — 91% — and that actions are underway to collect 95% of the uncollected premiums, the IRS has decided that the most judicious use of our enforcement resources would be to focus on those operators referred to us by the Combined Fund for delin quent premiums. Thus, we are working closely with the Fund to obtain this information on a systematic basis when they have determined willful nonpayment. To date, no referrals have been received from the Fund; thus, no penalties have been assessed.

Conclusion

In conclusion, our policy is that penalties should be used to foster voluntary compliance. It would not benefit the Fund, the beneficiaries, or the IRS to indiscriminately assess penalties against companies that are financially unable to pay the premiums. In these situations, a large penalty assessment would not result in collections to the Fund, but rather cessation of business operations and/or bankruptcy of the company. In these situations, a penalty does not encourage voluntary compliance with making the required payments under the Act.

Representatives of the Combined Fund are cooperating with the IRS to ensure that we do not indiscriminately and prematurely impose the sanctions under the Coal Act. We are, of course, ready to exercise both sanctions when entities flagrantly disregard the law.

Madame Chairman, this concludes my prepared remarks. I would be happy to answer any questions you or other Subcommittee members may have.

Mr. HERGER. Thank you.

Next is Dr. Lawrence H. Thompson, Ph.D., Principal Deputy Commissioner, the Social Security Administration. You are accompanied by Marilyn O'Connell, your Deputy Associate Commissioner.

STATEMENT OF LAWRENCE H. THOMPSON, PH.D., PRINCIPAL DEPUTY COMMISSIONER, SOCIAL SECURITY ADMINISTRATION; ACCOMPANIED BY MARILYN G. O'CONNELL, DEPUTY ASSOCIATE COMMISSIONER FOR PROGRAM BENEFITS POLICY

Mr. THOMPSON. Thank you, sir.

I am here to discuss SSA's role in administering this program. I am accompanied by Marilyn O'Connell, who has been directing implementation of our coal act responsibilities.

I will begin by briefly reviewing our responsibilities and then I will discuss our progress in carrying out these responsibilities.

The SSA was assigned three responsibilities under the coal act; first, to calculate the amount of the health benefit premium for each beneficiary; second, to assign each miner to a coal operator who will be responsible for the health benefit premiums for that miner and any beneficiary eligible because of the relationship to that miner, and to notify the operator of that assignment; third, to decide requests by the coal operators for review of the assignments.

SSA has calculated the premiums and notified the trustees of the combined fund of the premiums for each year since the law was enacted. We have also completed the process of making the initial assignments. As was required by law we completed that by October 1993.

The third of these responsibilities under the coal act, which has turned out to be very complex and time consuming, is the responsibility for reviewing the assignments when requested. The law provides that an assigned operator may, within 30 days of receipt of the assignment notice, request detailed information from us as to the work history of the miner and the basis for an assignment. The assigned operator then has 30 additional days, after receiving that information, to request a review of the assignment.

After the initial assignment notices were sent out, operators requested from us over 40,000 earnings records, as well as the basis on which the assignments were made for these 40,000 miners. Retrieving these records was a labor-intensive operation. The earnings information that we have since 1978 is available electronically, but earlier earnings information is maintained on microfilm and

requires manual searches.

We completed mailing out all of the requests for earnings records by February 1994. After the earnings records were sent to the assigned operators, the operators had 30 days to request a review. We received requests for review from 471 coal operators concerning the assignments of approximately 24,500 miners. The review requests were based on a wide range of allegations; for example, operators disputed that they were ever in the coal business, ever were a signatory to an agreement or that they should be considered a related company.

Because of the variety of the reasons the operators alleged for contesting assignments, we developed a two-stage process. First, we did a determination to see whether a company was in fact a coal operator eligible for assignment of miners. Those companies which were found not to be eligible for assignment were relieved of responsibility for any miners.

Having worked our way through most of the operators, we then went to the second stage, to review the earnings records of all the miners for whom there is a request for review, to determine whether the assignments should be adjusted, and, where adjustments were made, to determine who were the companies that seemed to be eligible for assignment.

The review process has been long and involved because of the difficulties encountered in attempting to secure documentation and in evaluating evidence submitted by the companies. In addition, some operators requested and were granted extra time, as much as 240 days to submit evidence. Much of the evidence submitted was old, incomplete and difficult to interpret. In addition, it was necessary to contact various organizations and agencies to determine the status and relationships of numerous companies.

We have now made decisions on 8,500 of the 24,500 cases included in the review requests. We have informed the requesters whether their appeal is allowed or denied. We will be sending out the new assignment notices by the end of the month.

We expect to have all of this first round of appeals finished by the end of September. Of course, the employers to whom these 24,500 cases were reassigned can appeal the reassignment, starting a new round of reviews and appeals.

By law, SSA cannot use trust fund moneys for work related to this program. Thus, SSA requested and Congress provided a supplemental appropriation of \$10 million for fiscal year 1993. Congress also approved a change in our administrative expense account language which permits us to use administrative funds to carry out the coal act and then be reimbursed subsequently.

To date, we have used essentially all the \$10 million of the initial appropriation. How much more we will need depends on how many appeals we get of the reassignments that we are now making. If we receive requests for reviews of subsequent assignments at a rate comparable to the rate that we have received for initial assignments, the additional cost could be as much as \$10 million.

In conclusion, we have been given a difficult and complex task. We have carried out our responsibilities of calculating the premiums and the initial assignment to the mine operators in the timeframe contemplated by the statute, but we are now in the midst of a complex process of working through the appeals and adjusting the status of the assigned miners when companies bring to our attention new facts about their corporate relationships.

I will be happy to answer any questions you have.

Thank you.

[The prepared statement follows:]

STATEMENT OF LAWRENCE H. THOMPSON PRINCIPAL DEPUTY COMMISSIONER OF SOCIAL SECURITY

Madame Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss the role of the Social Security Administration (SSA) under the Coal Industry Retiree Health Benefit Act of 1992 (Coal Act). Let me begin by briefly reviewing the requirements of the law and the responsibilities which were assigned to SSA. Then, I will discuss SSA's progress in carrying out these responsibilities.

Requirements of the Law

The Coal Act merged the 1950 and 1974 benefit plans of the United Mine Workers of America (UMWA) into a new "Combined Fund," administered by a board of trustees as a private tax-exempt employee benefit plan. This new Fund is designed to provide lifetime health benefits (and death benefits) for beneficiaries—of the old plans—retired miners and their dependents or survivors. Benefits are financed from funds transferred from UMWA pension plans, premiums paid by coal operators, and transfers of amounts from the Abandoned Mine Land Reclamation fund.

Under the law, coal operators pay premiums for all beneficiaries who are determined to be their responsibility. The premiums are established by formulas in the law. The law provides for them to pay a pro rata share of the premium cost for beneficiaries for whom no assignment of responsibility can be made (unassigned beneficiaries). However, because the Fund had adequate financing for the two years ending September 30, 1995, the coal operators did not have to pay premiums for unassigned beneficiaries for those years. With the plan year beginning October 1, 1995, these premiums will be transferred to the Fund by the Department of the Interior out of the Surface Mining Control and Reclamation Trust Fund.

SSA Responsibilities

SSA was assigned three responsibilities under the Coal Act:

- To calculate the amount of the health benefit premium for each beneficiary;
- o To assign each miner to a coal operator who will be responsible for the health (and death) benefit premiums for that miner and any beneficiaries eligible because of their relationship to the miner, and notify the operator of that assignment; and
- To decide requests by the coal operators for review of assignments.

Let me now briefly discuss each of these responsibilities.

Calculating the Premium

The law states that the health benefit premium amount is to be based on the average dollar amount of health benefits paid per person under the old plans for the plan year beginning July 1, 1991, updated to take account of the increase in the medical component of the Consumer Price Index (CPI). The law requires us to calculate the premium for each plan year beginning on or after February 1, 1993. The first plan year began on February 1, 1993, because that is the date the old plans were merged to create the Combined Fund. By law, subsequent plan years began on October 1, 1993, and each succeeding October 1.

The Coal Act requires that the premium calculation be based on the following information: (1) the aggregate amount of payments from both the 1950 UMMA Benefit Plan and the 1974 UMWA Benefit Plan for health benefits (less reimbursements but including administrative costs) for the plan year beginning July 1, 1991, for all individuals covered under the plans for

that plan year, and (2) the number of such individuals covered under the plans for that plan year. The aggregate cost divided by the number of individuals, increased by the percentage increase in the medical component of the CPI from 1992 to the year in which the plan year begins, produces the premium per individual.

SSA has calculated the premiums and timely notified the Trustees of the Combined Fund of the premiums for each year since the law was enacted.

Assignment Procedures

Our second task involved assigning responsibility for each miner to the appropriate coal operators. The Coal Act specifies the criteria we were to use.

The Combined Fund identified approximately 80,000 miners-both living and deceased--who were covered by the Act. The Bituminous Coal Operators Association provided us a list of approximately 15,000 of these miners for whom certain large coal operators voluntarily acknowledged premium responsibility. For these miners, and their dependents or survivors, we simply sent a confirming notice of assignment to the coal operators and to the Combined Fund.

The remaining 65,000 miners had to be assigned to a coal operator following the criteria set forth in the law. In general, there are three factors that are considered in determining to which coal operator a miner is assigned--length of a miner's employment with a coal operator who was a signatory to a UMWA wage agreement (also called a signatory operator), recency of that employment, and the date the wage agreement was aigned by the operator and the UMWA.

More specifically, the law states that a miner must be assigned to a coal operator according to the following order of priority:

- To the last active signatory operator (as defined previously) for whom the miner worked at least 2 years under a UMWA agreement (or if an inactive signatory, to its related company, if any) provided that the operator is also a 1978 signatory.
- To the last active signatory operator for whom the miner worked under a UMWA agreement (or if an inactive signatory, to an active related company, if any) provided the operator is also a 1978 signatory.
- To the active signatory operator of any agreement for whom the miner worked the longest under a UMWA agreement (or if an inactive signatory, to an active related company) in the period prior to 1978.
- o If no assignment can be made under the above criteria, the miner is treated as "unassigned." This means that, because responsibility for the premium cannot be assigned to a particular signatory operator, the miner is assigned to a pool, for which each assigned operator pays a pro rata share of the premiums.

Before we could even begin the assignment process, we had to develop lists of assignable coal operators. These lists were developed by SSA using information which was provided to us by the Bituminous Coal Operators Association and the UMWA, SSA employer records, information provided by operators in court suits and testimony in those suits, and other available sources of information on the coal mining industry, such as the Keystone Manual. It was very difficult to develop an accurate list of

coal operators because most sources of information on companies did not include the employer identification number which SSA records use to differentiate companies with similar (often identical) names. We used as much information as was available, such as similar addresses, but still had many companies erroneously included in the information provided by the UMWA. In fact, we continue to update the lists throughout the assignment process and the review process as we learn more about the companies.

In order to make an assignment using the criteria I described above, we must perform two separate operations: searching Social Security earnings records to reconstruct a miner's individual employment history; and matching that history against the lists of signatory coal operators and related companies who meet the above criteria and are still in business.

Once we have searched our earnings records to establish the miner's work history, we then use the criteria in the law to determine which coal operator is liable for the miner's health benefit premiums by matching the employment history with the lists of signatory operators.

We also use the information we obtained to identify any company which is "related" to a signatory company which is no longer in business. Under the Coal Act, the "related" company of a coal operator no longer in business may also be assigned responsibility for the miner's premium. Companies are related if they were:

- Members of a controlled group of corporations;
- A trade or business under common control with a signatory operator;
- Members with the signatory operator in a partnership or joint venture in the coal industry which employed eligible miners (but not a limited partner); or
- o A successor in interest to a related company.

If a signatory operator is no longer in business, we must determine whether there is a company which, as of July 20, 1992, or, if earlier, as of the time immediately before the operator ceased to be in business, was "related" to the signatory operator. If so, and if the related company is still in business, it becomes responsible for the beneficiary's premiums. In general, we based our determinations regarding related companies on the industry sources I mentioned previously.

SSA completed the process of making the initial assignment decisions by October 1, 1993, as required by law.

Review of the Assignment Decisions

SSA's third responsibility under the Coal Act, which has turned out to be very complex and time consuming, was to review each of the assignments, if requested by a coal operator. The law provides that an assigned operator may, within 30 days of receipt of the assignment notice, request detailed information from us as to the work history of the miner and the basis for the assignment. The assigned operator then has 30 days from receipt of that additional information to request review of the assignment. The statute requires the operator to provide evidence constituting a prima facie case of error in order to have the assignment reviewed.

After the initial assignment notices were sent to the assigned operators, operators requested over 40,000 earnings records, as well as the basis on which the assignments were made. In order to provide this information, SSA had to reconstruct some of the earnings records (which averaged eight pages per record) and provide copies of all of the earnings records with the justification for which each assignment was made to the operators.

Retrieving these records was a labor-intensive operation. Each earnings record contains a history of the miner's wages and the names and addresses of employers. While earnings information is electronically available beginning with wages reported for 1978, earlier earnings information is maintained on microfilm and requires a manual search. SSA completed the mailing of the earnings records by February 1994.

After the earnings records were sent to the assigned operators, the operators had 30 days to request a review of the assignment. SA received requests for review from 471 coal operators concerning assignments for 24,541 miners. The review requests were based on a wide range of allegations, for example, the company disputed that it was ever in the coal business, was a signatory to an agreement, or should be considered a related company.

Because of the variety of the reasons the operators alleged for contesting assignments, SSA developed a two-stage review process:

- o For those appeals in which the company alleged that it should not be assigned any miners because it was not a signatory to a UMMA wage agreement or is not in business, or due to a similar reason involving the status of the company, we did a first stage determination in one location to determine whether that company is in fact a coal operator eligible for assignment of miners. Those companies which were found not to be eligible for assignment were relieved of responsibility for all miners.
- o The second stage involves reviewing the earning records of all miners for whom there is an appeal from the original assignment. Those miners who were assigned to companies which were relieved of all assignments are reassigned to another company or to the unassigned pool. All others are either affirmed, reassigned, or included in requests for review which are denied because the operator did not file the request timely or failed to submit evidence.

The review process has been long and involved because of the difficulties encountered in attempting to secure documentation and in evaluating evidence submitted by the companies. In addition, some operators requested and were granted extra time to submit evidence. Some were granted up to 240 days to submit evidence. During the review process, all allegations and evidence submitted by the companies required extensive examination and evaluation. Many of the documents were court orders, legal business transaction papers, business permits, contracts, and pages from old business publications. Much of the data were old, incomplete, and difficult to understand. In addition, it was necessary to contact various organizations and agencies to determine the status and relationships of numerous companies. These contacts included State agencies, business bureaus, and public libraries which can verify the current status of certain businesses. We also contact the UMWA Fund to verify signatory agreements, dates of the agreements, and coverage status of employees.

We have completed virtually all of the stage one determinations and more than a third of the stage two determinations. Of the 471 requests, only 15 requests are still being considered at the first stage level. Decisions have been made regarding 8,417 of the 24,541 assignments reflected in these review requests. Of these, 4,930 assignments were modified (3,536 miners reassigned to other companies and 1,394 miners designated unassigned), 3,393 assignments were affirmed, and 94 were included in requests for review which were denied because the operator did not file the request timely or failed to submit evidence. Notices of affirmation and denial have already been released; reassignment notices are expected to be released by the end of June 1995.

If, after considering a request for review, SSA decides to change a miner's assignment, SSA applies the assignment criteria I described above to make the reassignment. Each new assignment is subject to the review process I described above. There are currently about 90 companies involved in litigation concerning the assignment of miners. Because the suits are still pending, I cannot discuss them.

Cost of SSA Workloads

The Coal Act did not provide funding for us to perform the work required of SSA. By law, SSA cannot use trust fund monies for work which is unrelated to Social Security programs. For this reason, SSA requested, and Congress provided, a supplemental appropriation of \$10 million for Fiscal Year 1993 to give SSA the necessary initial funding for this work. The funds were adequate to complete the assignments and begin the reviews. Congress also approved a change to SSA's 1994 administrative expense account appropriation language which permits SSA to use its administrative funds to carry out the requirements of the Coal Act and provides for reimbursement to the Social Security trust funds, with interest, not later than September 30, 1996.

SSA spent \$8 million of the supplemental appropriation in Fiscal Year 1993, and carried over \$2 million into Fiscal Year 1994. SSA spent another \$1.3 million of the supplemental in Fiscal Year 1994, and carried over \$0.7 million into Fiscal Year 1995.

If SSA receives requests for reviews of subsequent assignments at a rate comparable to the rate of requests for review of the initial assignments, we estimate the cost could increase by as much as \$10 million. We expect this amount to be spent over the Fiscal Year 1995-1996 period. Part of this work will be funded through the remaining supplemental appropriation, and the balance from the administrative expense account, with subsequent reimbursement from general revenues.

Conclusion

In conclusion, Madame Chairman, despite being given a difficult and complex task, SSA has carried out all of its responsibilities under the Coal Act concerning the calculation of premiums and the initial assignment of miners to operators. We continue the process of adjusting the status of the assigned miners as companies bring out new facts about corporate relationships and are processing the remaining requests for review as quickly as we can. I would be happy to answer any questions you may have.

Mr. HERGER. Thank you very much.

Mr. Brand, I appreciate your testimony.

Mr. Thornton, we want to welcome you before our Committee for the first time.

I would like to ask you a question.

Do you believe that the trustees have the discretion as to when

to impose penalties?

Mr. THORNTON. The trustees have a fiduciary responsibility to the fund to collect the maximum amount of revenues for the fund. In collecting premiums themselves, they have a certain amount of discretion to consider the costs involved in collecting the premiums versus the likelihood of collecting them. I think that once that process is completed, the responsibility for collecting the penalties is not with trustees, but with the IRS. So, in that sense the trustees do not have discretion to waive penalties but they have a certain amount of discretion with respect to collection of the premium itself.

Mr. HERGER. Thank you.

If discretion is needed, and it sounds like it might be in some instances; does that suggest that there is a problem with the act itself?

Mr. THORNTON. There may be an excessive penalty in the act. Currently, the penalty is \$100 per day per beneficiary and that can mount up to a sizable penalty in a short time. We would be willing to consider ways to adjust that penalty. As of yet, it has not been a problem because no one has been assessed that penalty.

I think Mr. Brand has explained in some detail why that has happened. Certainly, we could be willing to reopen and explore the

penalty structure of this act.

Mr. HERGER. Then the last question, are you satisfied that the fund trustees are meeting their common law and statutory duties under section 4980(b) of the Internal Revenue Code as fiduciaries?

Mr. THORNTON. We have no reason to think otherwise. Since the combined fund is a multiemployer nongovernmental benefit plan, the Labor Department has oversight responsibilities over the plan. To date, we are not aware of any irregularities that have required any particular action on the part of the Labor Department.

Mr. HERGER. Thank you.

The gentleman from Missouri, Mr. Hancock will inquire.

Mr. HANCOCK. I would like to get to the bottom line as quickly as possible.

Why should the Federal Government have any role in any privately financed, privately administered retiree health plan?

Mr. THORNTON. The Federal Government's role in this plan is actually fairly limited. The SSA, is involved in the assignment of employers and beneficiaries. IRS is involved in collection of penalties. The plan itself is a private nongovernmental fund run by trustees representing both coal companies and coal miners.

There is a transfer beginning in 1995 of moneys from the Abandoned Mine Land Fund to help defray the cost of orphan beneficiaries, but that is pretty much the extent of the Federal Government's involvement. I think at the time the act was enacted, it was recognized that this was a unique situation relating to the

coal mines going back to the Truman era of 1946.

Then Labor Secretary Elizabeth Dole's commission decided something more than collective bargaining would be needed to fix the situation. The previous administration was active in working out this compromise.

Having reviewed the bill, we have come to the conclusion that it was a reasonable solution to a very difficult situation, the main

objective being to make sure miners' benefits are provided.

Mr. HANCOCK. Here again, I think the actual answer to the guestion is of course that it got included in an act that nobody was in there when you get down to it. Very few people knew it was in there. At least the Ways and Means Committee did not know anything about it at the time.

Can you tell me how many penalty enforcement actions for failure to pay premium Treasury has initiated?

Mr. Brand. At this time, we have asserted no penalties and thus

no attempts to collect have been made.

Mr. HANCOCK. The trustees of the combined fund, are they providing you with names of individuals and corporations that are in arrears in paying their premiums to the fund as directed by the coal act? Are you getting this information?

Mr. Brand. There are two types of information.

First, there are sanctions that apply to the contributions during the transitional year. They furnished us information previously on companies that had not made those contributions. However, the sanction in that situation is a sanction that applies to a disallowance of certain deductions on the income tax return of the business entity. Since those returns had not yet been due, we have imposed none yet. Those returns now of course would have been due and presumably filed.

In our audit cycle, we will be into the returns this year that relate to that particular year of filing. We expect in August an updated list and we will put them into the return cycle and evaluate

them, whether we should examine that or not.

In terms of the penalties, we have not received a referral yet. It would appear that the compliance rate here is so substantial, and the referral of nonpayment would be from defunct small companies, so that the application of penalties wouldn't make sense.

Mr. HANCOCK. What is the SSA's involvement in this? I understand that there is quite a backlog of organizations that have appealed their assignments. Is that backlog problem being solved?

Mr. THOMPSON. Yes. We realized, after we made the initial round of assignments, when people came in to appeal, that a lot of the appeals had to do with whether a firm should have been assigned any miners. Did we have the wrong firm? We did not have the employer identification numbers for a lot of these firms. We had to guess at which firm it was and we got some wrong.

Then there were questions about whether this firm was a legitimate successor of a firm that had been in the coal business. It was clear we were going to have to work through all of those issues before we reassigned coal miners or else we would just be reassigning coal miners from one firm to another firm that shouldn't have been

assigned a coal miner in the first place.

We have spent a good deal of time sorting through to make sure that our list of companies eligible to be assigned a miner was a valid list. We think we have that pretty well straightened out and now we are actually assigning the miners. That has been the delay. We should have that wrapped up for this round in another couple of months.

We have about 24,500 miners involved in requests for review. I said in the testimony we have 8,500 that were assigned as of a week ago. We think the other 16,000 will be taken care of in the next couple of months.

Mr. HANCOCK. I understand that there have been some 200 companies that were initially notified that they might have some liability under this act, that have been released from all liability; is that correct?

Mr. THOMPSON. That is about right.

Mr. HANCOCK. Would you give me an estimate of how many companies that you did not find? Are you convinced that you found

all the companies that you were supposed to find?

Ms. O'CONNELL. Let me answer that. In the initial round, we found a lot of wrong companies and that is the 200 you are talking about. As we have gone through the appeals, through the evidence furnished by the companies in the appeals, we have identified companies that did not receive assignments in the first round that will when we do the reassignments. For example, we may have had 20 companies with identical names and very close addresses, and we got the wrong one. Now we presumably have the right one. So, I do not have an estimate of that number until we have done the reassignments, but we will have identified companies who did not receive assignments in the first round.

Mr. HANCOCK. Are you telling me that there are companies out there now that are going to get a notice in the near future that they owe money into a pension plan or into a health benefit plan that were not a party to the contracts and do not know anything

about it?

Mr. THOMPSON. They were presumably a party to the contract but previously we had identified a different company and now we realize we made a mistake.

Ms. O'CONNELL. They have to have been a signatory during the appropriate period and the miner had to have worked for them or a predecessor company in the right period, so they would have been

a party to the contract.

Mr. HANCOCK. Is it unusual in our scheme of things to have companies that have changed hands a number of times, and have not been in the coal business for maybe 20, 25 years, to later find that there is a contingent liability that the new owners are not aware of and had no record of. Do you know of another instance where we have done something like this?

Mr. THOMPSON. That has arisen several times. I will defer to somebody else on the question of whether that is reasonable or not.

Mr. HANCOCK. I think we know the answer to that.

Mr. THOMPSON. It has happened a couple of times.

Mr. HANCOCK. Can you give me a specific where it has happened?

Mr. THOMPSON. No.

Mr. HANCOCK. Are we going back to 1950 and telling people that they owe money for employee benefit plans?

Ms. O'CONNELL. That is correct.

Mr. HANCOCK. You cannot think of any other time?

Ms. O'CONNELL. Eastern Enterprises is no longer in the coal business. They sold that part of the company, and received assignments for that reason.

Mr. HANCOCK. I understand. The bill that we have introduced, I want to reiterate, is not going to take any benefits away from the miners that are retired. However, I think it is a case of who is going to pay for it rather than taking away any benefits. That certainly is not our position at all.

Thank you, Madam Chairman.

Chairman JOHNSON [presiding]. Thank you.

I did not get a chance in my earlier statement to welcome you, Mr. Thornton. This is your first opportunity to be on the other side.

Mr. THORNTON. Thank you very much.

Chairman JOHNSON. We appreciated your service on the Committee and we appreciate your service in the executive branch.

Mr. THORNTON. It is an honor to be here.

Chairman JOHNSON. Are you having any problems with the premium dollars flowing in and the way they were anticipated? In other words, are people paying and are they paying the amount

that you expect them to pay?

Mr. BRAND. I might respond to that. The collection of the premiums is with the fund itself, the combined fund. But the indications are that 91 percent of the premiums are being paid timely and that another 5 percent are subject to various types of arrangements such as escrow, litigation or bankruptcy, so there is a high degree of compliance in the actual payment of the premiums.

The understanding is that the unpaid premiums are small amounts spread among a number of small companies that in many,

many instances are insolvent or bankrupt themselves.

Chairman JOHNSON. The figure that we were given was that

there were 200 companies that were delinquent.

Mr. Brand. My understanding is that the 200 companies are not necessarily delinquent. They are in various stages of appeals or may have been relieved of responsibility or may be in bankruptcy. I believe that may be a question that is better asked of the fund representatives themselves. They would have that information.

Chairman JOHNSON. We will certainly do that.

Mr. Zimmer.

Mr. ZIMMER. Thank you, Madam Chairman.

I would like to ask Dr. Thompson and Ms. O'Connell whether you are familiar with the very recent Federal District Court case of the National Coal Association against Secretary Shalala, which was decided June 2 of this year and held that the SSA did not properly compute the premium amount under the 1992 coal act?

Mr. THOMPSON. I have heard of the case. I have been told that

the case was decided.

Mr. ZIMMER. Can you tell the Subcommittee whether the SSA

plans to appeal this decision?

Mr. THOMPSON. The staff is evaluating that and they haven't brought me a recommendation yet, so I cannot tell you today what we are going to do.

Mr. ZIMMER. Does the staff consider this decision to be an important one?

Mr. THOMPSON. I am sure.

Mr. ZIMMER. Do you know approximately what the total amount of premiums annually is and the total that could be eliminated if the National Coal Association case is upheld on appeal?

Mr. THOMPSON. I would rather supply that for the record.

Mr. ZIMMER. Certainly. I have no further questions. Thank you.

[The following was subsequently received:]

The figures in the first column are the per beneficiary premiums for each of the plan years as determined by SSA. The second column shows what the per beneficiary premium for each year would have been had they been computed using the method determined by the District Court to be the correct computation method. Since SSA does not have information about totals of premiums billed by the combined fund, we cannot determine the total effect of the court decision.

Per Beneficiary Premium	Original	Court Case
1st Plan Year (02/01/93-09/30/93)	= \$2,245.83	\$2,013.83
2d Plan Year (10/01/93-09/30/94)	= 2,245.83	2,013.83
3d Plan Year (10/01/94-09/30/95)	= 2,349.38	2,106.68

Chairman JOHNSON. I thank the panel for your testimony this morning and for your assistance in the future.

[Additional written Subcommittee questions and the responses submitted to IRS and Treasury follow:]

QUESTIONS FOR TREASURY AND THE INTERNAL REVENUE SERVICE.

- How many penalty enforcement actions for failure to pay premiums has the Treasury initiated, pursuant to section 9707 of the Internal Revenue Code?
- A. Taking into account the high level of compliance and that actions are underway to collect 95 percent of the delinquent premiums, the IRS has decided that the most judicious use of its enforcement resources would be to focus on those operators referred to the IRS by the Combined Fund for delinquent premiums. The IRS is working closely with the Fund to obtain this information on a systemic basis when they have determined willful nonpayment. To date, no referrals have been received from the Fund; thus, no penalties have been assessed.
- 2. Are the trustees of the Combined Benefit Fund providing you with the names of individuals or corporations who are delinquent in making their premium payments?
- A. Information from the Combined Fund indicates that 91 percent of the assessed premiums have been paid. The Fund has also indicated that proofs of claim, settlement negotiations, suits or other actions are pending for 95 percent of the uncollected premiums. It would not benefit the Fund, the beneficiaries, or the IRS to indiscriminately assess penalties against the companies that are financially unable to pay the premiums. Representatives from the Fund are cooperating with the IRS to ensure that we do not indiscriminately and prematurely impose the sanctions under the Coal Act.
- 3. Is it the responsibility of the Treasury Department to inquire as to whether the premiums due the Fund under the Act are actually being paid? Or do you simply wait for referrals of non-payers from the Fund?
- A. The statute does not address the reporting of delinquent operators by the Combined Fund. As noted in the answer to question 2, the IRS has met with Fund representatives regarding the coordination of collection efforts with the implementation of the penalty.
- 4. There are some reports that there are more than 200 delinquent companies.
 If you have not received referrals from the Fund, does that concern you?
- A. The number of delinquent companies does not reflect the amount of uncollected premiums. Our discussions with the Combined Fund indicate that 91 percent of the assessed premiums have been collected. Of the amounts that have not been collected, almost half are either the subject of escrow agreements with operators contesting the constitutionality of the Act or are attributable to operators known to be the subject of bankruptcy proceedings. The remaining uncollected premiums are spread among small insolvent or defunct operators and have been determined to be not collectible by the Fund.
- 5. Do you believe the Trustees have discretion as to when to impose penalties?
- No. The Trustees do not impose penalties and therefore have no discretion whether to impose penalties.

- 6. Does the Treasury or the Service have some discretion as to when to impose penalties?
- A. Under the statute, the Secretary of Treasury may waive all or part of the penalty, in the case of a failure that is due to reasonable cause and not to willful neglect, to the extent that it is determined that the payment of the penalty would be excessive relative to the failure involved.
- If discretion is needed, does that suggest that there is a problem with the Act itself?
- A. As stated in our testimony, we are concerned that the penalty may be excessive in certain cases, and a revised penalty structure may provide a better enforcement tool. However, we do not believe that this issue reflects problems with the basic financing structure of the Act -- requiring former employers to finance the health benefits promised to retired miners and their families.
- 8. Are you satisfied that the Fund Trustees are meeting their common law and statutory duties under section 4980(B) of the Internal Revenue Code as fiduciaries?
- A. The Coal Act provides that the Combined Fund is a plan described in section 302(c)(5) of the Labor Management Relations Act of 1947 (LMRA), an employee welfare benefit plan within the meaning of section 3(1) of the Employee Retirement Income Security Act of 1974 (ERISA) and a multiemployer plan within the meaning of section 3(37) of ERISA. The fiduciary duties are under ERISA. Both the LMRA and ERISA are administered by agencies in the U.S. Department of Labor.
- Have you received adequate funding from the Congress to carry out your penalty enforcement responsibility under the Act?
- A. The IRS did not receive any additional funding to administer the penalty provisions of the Coal Act. It does not benefit the Fund, beneficiaries, or the IRS to assess penalties against companies that are financially unable to pay the premiums or in cases where a penalty assessment will result in cessation of business operations or bankruptcy of the company. Additionally, it would not be a judicious use of IRS resources to assess penalties in these situations.
- 10. Do you have adequate personnel to carry out your penalty enforcement responsibility under the Act?
- A. Since the IRS did not receive additional funding to administer the Coal Act, resources to enforce the penalty provision would be redirected from other compliance activities. The IRS is ready to impose the sanctions in the Act when a penalty assessment will encourage voluntary compliance with making the required payments under the Act.

We will proceed with the next panel.

Russell Crosby, acting executive director of the United Mine Workers; John Ladley, partner, Ernst & Young; and Jeffrey Gathers, principal, Towers Perrin, Cleveland, Ohio.

Mr. Crosby, if you will proceed.

As we mentioned earlier, your full statement will be included in the record, and we ask you to summarize.

STATEMENT OF RUSSELL U. CROSBY, ACTING EXECUTIVE DIRECTOR, UNITED MINE WORKERS OF AMERICA, HEALTH AND RETIREMENT FUNDS

Mr. Crosby. Good morning, Madam Chairman, gentlemen.

I am Russell Crosby, acting executive director of the UMWA Health and Retirement Funds.

Thank you for inviting me here today to review the status of the UMWA Combined Benefit Fund and the UMWA 1992 Benefit Plan.

In 1992, when Congress passed the coal act, it created both the combined fund and the 1992 plan. Today, the combined fund serves over 92,000 retired miners and their dependents. With an average age of 73, almost 90 percent are eligible for Medicare and about 20 percent also receive Federal black lung benefits.

Four thousand three hundred retired miners and their dependents receive benefits from the 1992 plan, with an average age of 51, and about 44 percent eligible for Medicare; 5 percent also receive Federalblack lung benefits.

The combined fund receives financing from three sources, first, the beneficiaries themselves participate by the transfer of \$210 million from the 1950 Pension Trust. This has covered the cost of benefits for unassigned or orphan beneficiaries in the first 3 years of the fund's existence. Transfers of interest from the Abandoned Mine Reclamation Fund are expected to pay for benefits for the unassigned pool of beneficiaries for another 10 years.

Second, companies that signed the 1988 Coal Wage Agreement pay premiums for beneficiaries assigned to them. They paid for the combined fund's first year operations as well. Those companies also fund the 1992 plan while continuing single employer health plans

for their retirees.

Third, reach-back companies pay premiums for retired miners and dependents who worked for them and are now assigned to them under the act. This parallels the premium obligation of the

companies that signed the 1988 Coal Wage Agreement.

Both the combined fund and the 1992 plan have contracted with United Health Care Corp., a national leader in health care management, to provide claims administration and cost management services on a prepaid risk basis. United is now developing managed care initiatives to maximize the cost efficient delivery of benefits.

Health care cost-containment is not new to retired miners. The 1950 and 1974 benefit plans began cost-containment programs in 1984, with the result that for comparable services, the UMWA Benefit Trust had per capita expense trends almost 1 full percent below those of the Medicare Program.

In 1990, HCFA approved the funds' demonstration program for Medicare part B services. Since then, Medicare has paid the fund a negotiated flat fee per beneficiary and the fund assumed the risk

of providing part B services within that cost.

During the first years of the demonstration, the fund received more in payment than the cost of services, primarily by reducing medical fees. This is the source of most of the combined fund's net asset balance. However, for the current year and the anticipated future, the combined fund is expected to break even on the arrangement because Medicare has significantly reduced the amount it pays us.

The trustees are concerned about the likely effect on the combined fund of any overall reduction in Medicare benefits. Such a development can only increase the risk of future shortfalls in

income in relation to the cost of benefits.

A new demonstration proposal to extend the Medicare capitation arrangement to cover part A as well as part B services has been submitted to HCFA. While the proposal is under consideration, the fund and United Health Care are working to develop networks and other managed care interventions to maximize the quality of care while minimizing cost.

We believe that these benefit plans are a model of the kind of health care delivery and payment systems that the Congress has

hoped to promote nationally.

While Guy King of Ernst & Young will discuss the financial outlook of the combined fund, I can summarize the current picture. The fund's audited financial statements show that for the plan year ended September 1994, the Combined Benefit Fund had net assets of \$114.8 million. It provided \$338 million in medical benefits, of which \$159 million were covered by Medicare and black lung payments. In addition, death benefits of almost \$13 million were paid out.

Roughly, \$92 million of the combined fund's net asset balance comes from the Medicare relationship, not premiums paid by employers. Other sources include collection of pre-coal act delinquencies and credits of first-year contributions made by companies that signed the 1988 Coal Wage Agreement but had no

beneficiaries assigned.

Audited financial statements for the 1992 plan for the year ended December 31, show it had net assets of \$1.3 million. During that year, the plan provided almost \$10 million in medical benefits of which \$2 million was covered by Medicare and black lung payments.

In October 1993, Social Security provided a list of companies with beneficiary assignments and the fund immediately billed all companies the premiums owed for their retirees and their depend-

ents.

Companies appealed over 35,000 of the individual beneficiary assignments but Social Security expects to complete the appeals process this fall. These ongoing appeal decisions have caused a shifting of liability among companies as well as to the unassigned pool.

To ensure that premiums owed are paid, we maintain a systematic and aggressive program to collect delinquent contributions. While the coal industry includes a number of large, financially stable companies who reliably contribute to the fund, it also has

many small undercapitalized employers who start up and then shut down after a short time, often falling delinquent in the process.

Bankruptcies are also common in the industry, but we have not observed a significant increase in bankruptcy filings since the passage of the coal act. There was an annual average of 44 new bankruptcy filings involving the funds in each of the 5 years prior to the coal act, but there were only 36 new bankruptcy filings in the year after the coal act became effective.

Under the coal act, the combined fund beneficiaries are assigned to 688 different companies which are part of 520 control groups. So far, 215 of these companies have been relieved of liability as a result of Social Security appeal decisions.

Approximately 91 percent of assessed premiums have been paid. Of the \$30 million of delinquent premiums, about half is owed by two companies, one of which has entered into an escrow-type arrangement.

A total of 217 operators were delinquent as of March 1995. We are in the process of suing, filing proofs of claim or negotiating settlements in matters covering approximately 95 percent of the delinquent premiums owed by these companies. The remaining 5 percent is owed by numerous small employers who were assigned small numbers of beneficiaries. Many of these are out of business or have filed potentially successful appeals from their assignments.

While the uncertainties resulting from the Social Security appeals process have prevented final calculations of premium shortfalls or surpluses for the first two plan years, premiums appear to have fallen short of expenses.

The trustees asked Guy King of Ernst & Young to prepare actuarial projections of the combined fund's financial position over the next 10 years. As the former Chief Actuary of the Health Care Financing Administration, Mr. King is uniquely qualified for this work.

You have his report.

Mr. King has also explained the reasons why the projections of large surpluses found in the Towers Perrin study are improbable. Towers Perrin apparently relies on inconsistent assumptions, they assume that the combined fund's future cost trends will grow at a dramatically lower rate, but that the MCPI, which governs future premiums, will not experience a corresponding downward movement.

The fund's cost trends are closely linked to Medicare, and Medicare makes up a large portion of the MCPI. As Mr. King will explain in more detail, the pattern of premiums falling short of expenses is likely to continue into the future. The assets gathered from the Medicare Program and prior period collections will be needed to cover these future shortfalls.

I am now prepared to respond to any questions the Committee might have.

Thank you. Mr. Ladley.

[The prepared statement follows:]

STATEMENT OF RUSSELL U. CROSBY ACTING EXECUTIVE DIRECTOR OF THE UMWA HEALTH AND RETIREMENT FUNDS

Before the House Ways and Means Committee Subcommittee on Oversight June 22, 1995

Good morning, Madam Chairman and Members of the Subcommittee. It is my pleasure to be here today to address your inquiries concerning the administration of the UMWA Combined Benefit Fund and the 1992 UMWA Benefit Trust in accordance with the provisions of the Coal Industry Retiree Health Benefit Act of 1992 ("Coal Act").

HISTORICAL PERSPECTIVE

Before I discuss the specifics of the operations of these two funds, let me first provide you with some important background information. As you know, the provision of retiree health benefits in the coal industry has a long history dating back almost 50 years to the agreement between the then Secretary of the Interior, Julius A. Krug and John L. Lewis, President of the United Mine Workers of America ("UMWA"). The Krug-Lewis Agreement established an unprecedented system for providing health and pension benefits to active and retired miners and their families. Through subsequent collective bargaining agreements between the UMWA and the Bituminous Coal Operators' Association, Inc. ("BCOA"), this comprehensive health delivery system was carried forward, funded by contributions paid to the health trusts by signatory employers.

The health delivery system that was established through collective bargaining has been continuously administered by the UMWA Health and Retirement Funds ("Funds"), which is a collective reference to the family of employee benefit trusts that provide health and pension benefits to eligible miners and their eligible dependents. Prior to the enactment of the Coal Act, the Funds consisted of five trusts: the UMWA 1950 Pension Trust, the UMWA 1950 Benefit Plan and Trust, the UMWA 1974 Pension Trust the UMWA 1974 Benefit Plan and Trust, and the UMWA Cash Deferred Savings Plan of 1988.

THE COAL COMMISSION

By the late 1980s the UNWA 1950 and 1974 Benefit Trusts were in deep financial difficulty due to the diminishing number of contributing employers, rising costs and especially the relative growth of the population of "orphan" beneficiaries, those whose signatory employers had either gone out of business or refused to sign subsequent National Bituminous Coal Wage Agreements ("NBCWA") and stopped contributing. In 1989, then Secretary of Labor Elizabeth Dole created the Advisory Commission on United Mine Workers of America Retiree Health Benefits ("Coal Commission") to evaluate the problems facing the Funds and to propose a long term solution. After study, the Coal Commission projected that the financial difficulties of the 1950 and 1974 Benefit Trusts would worsen, resulting in a combined deficit of \$300 million by 1993. The Commission also recognized that

Retired coal miners have legitimate expectations of health care benefits for life; that was the promise they received during their working lives and that is how they planned their retirement years. That commitment should be honored. (Coal Commission Report at 1.)

Consequently, the Coal Commission made a number of recommendations, including a recommendation that companies signatory to past National Bituminous Coal Wage Agreements ("NBCWAs") should bear the cost of providing health benefits to their own retired miners. The Coal Commission also recommended that current and former signatory employers collectively share the cost of providing health benefits to retirees whose employers no longer existed ("orphan" miners). According to the Commission, the fairest method of financing this promised health care encompassed the "imposition of a statutory obligation to contribute on current and past signatories, mechanisms to prevent future dumping of retiree healthcare obligations, authority to utilize excess pension assets and the implementation of state-of-the-art managed care and cost containment techniques." (Coal Commission Report at 60.)

THE COAL ACT

In October 1992, Congress enacted the Coal Act as part of the Energy Act of 1992. It is a stated policy of the Coal Act "to provide for the continuation of a privately financed self-sufficient program for the delivery of health care benefits..." to coal industry retirees. This policy is effectuated through the identification of the "persons most responsible for plan liabilities in order to stabilize plan funding and allow for the provision of health care benefits to such retirees."

The Coal Act merged the 1950 and 1974 Benefit Trusts into a new private trust fund called the UMWA Combined Benefit Fund. Beneficiaries of the 1950 and 1974 Benefit Trusts as of July 20, 1992 are now covered by the Combined Benefit Fund, which has a statutory mandate to provide benefits on a prepaid risk basis and, to the maximum extent feasible, substantially the same coverage that was provided under the 1950 and 1974 Benefit Trusts as of January 1, 1992.

The Coal Act provides for financial stability of the Combined Benefit Fund by drawing from three constituent sources. First, the beneficiaries themselves were required to participate by the transfer of \$210 million from the 1950 Pension Trust in three installments of \$70 million in each of the first three plan years. This has been enough to cover the cost of providing benefits to the "unassigned" or orphan beneficiaries in the Combined Fund during these years. (For an additional ten years, transfers from the Abandoned Mine Reclamation Fund are expected to continue to cover this unassigned beneficiary cost.)

Second, operators who signed the 1988 NBCWA are required to pay premiums for beneficiaries assigned to them and a proportionate share of the death benefit cost and the cost of unassigned beneficiaries, to the extent this cost is not covered by the transfers described above. They were also required to advance funds to cover the first plan year's operations. In addition, the 1988 agreement operators provide the guaranteed funding of the 1992 Benefit Plan and are required to continue the single employer health plans for retirees in place as of the effective date of the Act. The creation of the 1992 Plan and continuation of the single employer plans contribute to the stability of the Combined Fund by allowing for the closed population of the Combined Fund, limiting the potential growth of its expenses.

Third, the coal industry operators who signed Coal Wage Agreements prior to 1988, often referred to as "reachbacks," are required to pay premiums for beneficiaries assigned to them and a proportionate share of the death benefit cost and the cost of unassigned beneficiaries, to the extent that this cost is not covered by the transfers described above. This obligation of the reachbacks parallels the 1988 agreement operators' premium

obligation. However, unlike the 1988 agreement operators, the reachbacks have no other obligations. Moreover, under the assignment criteria of section 9706, retirees are generally assigned to the employers who employed them more recently, so that a retiree who worked first for a reachback company and later for a 1988 agreement operator would be assigned to the 1988 agreement operator.

Pursuant to the Act, the UMWA and the BCOA created the UMWA 1992 Benefit Plan to provide health benefits to a class of orphan beneficiaries not cowered by the Combined Fund. This class includes beneficiaries who would have received benefits from the 1950 or 1974 Benefit Trusts but were excluded from the Combined Fund by its cut-off date of July 20, 1992. It also includes those beneficiaries whose employers have failed in their duty under the Act to provide benefits under single employer plans. Beneficiaries of the 1992 Benefit Plan must derive their eligibility from mine workers meeting the age and service requirements for eligibility as of February 1, 1993, who have retired on or before September 30, 1994. Thus the maximum number of potentially eligible beneficiaries of the 1992 Plan is the number who could be eligible for benefits under single employer plans mandated by section 9711.

The 1992 Benefit Plan is funded by two kinds of premiums. Prefunding premiums are paid by all 1988 agreement operators who maintain single employer plans under the Act, based upon the roughly 62,000 beneficiaries in such plans, as they are all potentially eligible beneficiaries of the 1992 Plan. Per beneficiary premiums are owed by employers who last employed beneficiaries actually receiving benefits from the 1992 Plan.

DEMOGRAPHICS OF THE COMBINED BENEFIT FUND AND THE 1992 PLAN

There are currently 92,083 retired miners and dependents covered by the Combined Benefit Fund. These beneficiaries, on average, are over 73 years old. Approximately 36% of Combined Fund beneficiaries are over 80 years old and that number is expected to exceed 50% in the next 6 years. Over 88% of Combined Benefit Fund beneficiaries are eligible for Medicare benefits and more than 19% of these beneficiaries also receive federal Black Lung Benefits.

There are 4,301 retired miners and dependents covered by the 1992 Benefit Plan. The average age of this population is 51; approximately 44% are eligible for Medicare benefits and 5% also receive federal Black Lung benefits.

Beneficiaries of the Combined Benefit Fund and the 1992 Benefit Plan are spread across the United States. However, the heaviest concentrations of beneficiaries are found in the coal field areas in southern West Virginia, western Pennsylvania, Ohio, Virginia, Kentucky, Alabama, Illinois, Tennessee, Florida and Indiana.

COVERED BENEFITS

Pursuant to the Coal Act, the health benefits provided to eligible beneficiaries under both the Combined Benefit Fund and the 1992 Plan is a continuation of the level of coverage that was provided by the former 1950 and 1974 Benefit Trusts. That plan of benefits is designed to provide beneficiaries with access to high quality health care with minimal out-of-pocket expenses while also containing costs. The Trustees do, however, have authority under the Coal Act to make certain revisions to the health plan in order to preserve its financial solvency. At the present time, covered services include inpatient and outpatient hospital care, physician and other primary care services, insulin

and prescription drugs, skilled nursing care and extended care, certain home health services and other benefits such as vision care, durable medical equipment, hearing aids and necessary ambulance services. For services that are covered by the plans, the cost sharing requirements are a \$5 copay per physician visit, up to annual maximum of \$100 per family, and a \$5 copay per 30-day prescription or refill, up to an annual maximum of \$50 per family. Beneficiaries are also protected by the Funds' Hold Harmless program against costs resulting from certain payment denials (i.e. charges that are denied payment as medically unnecessary or as excessive fees).

ADMINISTRATION OF THE PLANS

Both the Combined Benefit Fund and the 1992 Benefit Plan provide a "one stop shopping" approach for eligible beneficiaries and their providers. The Funds has processed and paid Medicare benefits on behalf of its beneficiaries since the inception of the Medicare program in 1965. Pursuant to the continuation of an arrangement with the Health Care Financing Administration ("HCFA"), the Funds pays Medicare Part B benefits (except for those Part B services that are processed by the Part A fiscal Intermediaries) for the Medicare eligible beneficiaries of the Combined Benefit Fund and the 1992 Benefit Plan. In addition, under an arrangement with the U.S. Department of Labor entered into in 1984, the Funds administers the health benefits portion of the federal Black Lung program for Funds' beneficiaries. Thus, plan benefits "wrap around" both the Black Lung and Medicare benefits.

As a result of a competitive bidding process, effective January 1, 1995, the Trustees of the Combined Benefit Fund and the 1992 Benefit Plan contracted with the United HealthCare Corporation ("UHC") for the delivery of administrative and cost management services to their beneficiaries. UHC is a large, well-recognized, national leader in the health care management industry. Pursuant to its agreements with the Combined Benefit Fund and the 1992 Benefit Plan, UHC assumed the administration and management of the health care benefits of each fund on a prepaid risk basis. UHC is now developing managed care initiatives to continue cost efficient delivery of benefits to this population.

Although some of the UHC initiatives will be new, the idea of cost containment in health care is not new to the UMWA Benefit Funds' population. The UMWA 1950 and 1974 Benefit Plans began successful cost management programs under the NBCWA of 1984 and expanded those programs under the NBCWA of 1988. Because of these programs, the 1950 and 1974 Benefit Trusts experienced significantly lower rates of cost increase per beneficiary than did the national population and dramatically lower rates than populations of comparable age. As the Ernst and Young study demonstrates, in a comparison of comparable services, from 1986 through 1994, the UMWA Benefit Trusts have had a per capita expense trend of increase of 0.8% below the trend of increase for the Medicare program.

Among the most successful cost management programs of the UMWA Health Funds prior to the formation of the Combined Fund were a national medical fee limit program, a drug pricing program based on negotiated acquisition cost for prescription drugs, strict limits on fees for durable medical equipment, including oxygen, drug and medical utilization review, including rebundling of lab and surgery fees, and promotion of the use of generic drugs. While the 1950 and 1974 Benefit Trusts paid providers on a fee for service basis with beneficiaries free to choose providers, the beneficiary population has always been extremely cooperative with the Funds' cost containment efforts, and this has enabled the Funds to negotiate for providers' cooperation in

programs to reduce costs. The Funds has maintained good communications with beneficiaries and providers to implement these programs through staff members at eight field service offices in the coalfields and through frequent mailings of information in beneficiary news letters.

THE MEDICARE ARRANGEMENT

As I mentioned earlier, the Funds has enjoyed a longstanding relationship with the Medicare program. At the time the Medicare Act was passed in 1955, the Funds provided most physician and related services through clinics in the coalfields that it helped sponsor. These clinics were paid on a retainer or other non-fee-for-service basis. However, starting in 1978, a fee-for-service system that embodied freedom-of-choice of providers was adopted. At the inception of the Medicare program, the Funds became a Group Practice Prepayment Plan and subsequently assumed its current status as a Health Care Prepayment Plan ("HCPP"). For a number of years, Medicare reimbursed the Funds for its beneficiaries' Part B medical and administrative expenses on a "reasonable cost" basis. That arrangement changed in 1990 when HCFA approved the Funds' demonstration proposal and entered into a capitation agreement for Part B services. Pursuant to that arrangement, HCFA pays the Funds a negotiated flat fee per beneficiary per month and the Funds assumed the risk of providing the Medicare Part B services for that fee. To the extent that these benefits cost less than the monthly fee to provide the services, the excess monies are the Funds' to keep and use to pay other benefits. However, HCFA's liability is also capped. Consequently, if the cost of Medicare services exceed the HCFA payments, the Funds must absorb the difference.

During the first years of the Medicare demonstration, the Funds received more in payment than the cost of services, and this is the source of most of the Combined Funds' current net assets. However, for the current year and the anticipated future, the Funds are expected barely to break even on the arrangement.

In January 1995, the Funds, on behalf of the Combined Benefit Fund and the 1992 Benefit Plan, submitted a demonstration proposal to HCFA to extend the capitation arrangement to cover Part A as well as Part B services for its beneficiaries. The Funds developed this proposal jointly with United HealthCare as a means of more effectively managing the health care costs of the Combined Benefit Fund's and the 1992 Benefit Plan's elderly population. The proposal is under consideration at HCFA. In the meantime, the Funds and UKC are moving forward with the development of networks and other managed care interventions to maximize the quality of care received by beneficiaries while minimizing cost.

COAL ACT ASSIGNMENTS

Under the Coal Act, the Secretary of Health and Human Services was required to assign beneficiaries to operators in accordance with certain attribution rules that are set out in the Act. 26 USC Section 9706. Beneficiaries who could not be assigned using the assignment rules set forth in the Coal Act are placed in the unassigned pool. As required by the Coal Act, the Fund transmitted to the Secretary information relating to the benefits and covered beneficiaries under the former 1950 and 1974 Benefit Plans and financial information for the Secretary's use in the calculation of the annual health premium. The Funds has also provided information as requested by the Secretary concerning the signatory status of operators and the work histories of covered beneficiaries for use in the assignment process.

In October 1993, the Secretary provided the Funds with a comprehensive list of assignments, and the Funds immediately billed all assigned operators and their related persons for the premiums and has pursued collection of the monies owed to the Fund. However, many operators appealed the assignments made by the Secretary--over 35,000 individual beneficiary assignments have been appealed--and the Secretary expects to complete that appeal process in the Fall of 1995. As a result of the appeals, there has been a shifting of liability among operators, as well as to the unassigned pool. The Funds hopes that much of the liability will be finally established by early next year. In the meantime, the Funds tracks the appeals decisions made by the Secretary, making adjustments to operator billings where appropriate.

FINANCIAL STATUS OF THE COMBINED BENEFIT FUND

Although Guy King of Ernst & Young is here today to discuss the financial outlook of the Combined Benefit Fund, let me briefly summarize the current financial picture of that Fund. The most recent audited financial statements of the Combined Benefit Fund show that for the plan year ended September 30, 1994, the Combined Benefit Fund had net assets of \$114,829,000. During that plan year, the Combined Benefit Fund provided medical benefits to beneficiaries in the amount of \$319,211,000, of which \$159,280,000 was covered by Medicare and DOL (black lung) payments. In addition, \$12,653,000 in death benefits was paid to the families of deceased beneficiaries.

As I stated earlier, most of the Combined Funds' net assets, approximately \$91.5 million of the total of \$114.8 million, comes from the margin of success in the early Medicare capitation program. Other sources have been collections of pre-Coal Act delinquencies and credits of first year contributions of 1988 Agreement operators. While the uncertainties resulting from the Social Security Administration appeal process have prevented final calculations of premium shortfalls or surpluses for the first two plan years, we can discern that premiums appear to have fallen short of expenses for these years. Therefore, premium payments have not been the source of the net assets. As Mr. King will explain in more detail, it appears most likely that this pattern of premium shortfalls will continue into the future, so that the assets gathered from the early years of the Medicare demonstration program and collections of past obligations are likely to be needed to cover these shortfalls.

The figures presented here are from our statements of accrued assets and liabilities. It is important to note that Generally Accepted Accounting Principles require accrual-based accounting for employee benefit plans that pay health care claims. This is because of the fact that health care services are received by beneficiaries months and even years before the plan receives, processes and pays the providers' bills. Thus, the cash receipts for any given period, even up to a year, are not likely to correspond to the cash disbursements for the same period. The appearance of cash surpluses or shortfalls at any given time is, therefore, never a good indication of the plan's financial position.

FINANCIAL STATUS OF THE UMWA 1992 BENEFIT PLAN

I also will present a brief summary of the financial situation of the 1992 Benefit Plan. The most recent audited financial statements for the plan year ended December 31, 1994 show that the 1992 Benefit Plan had net assets of \$1,295,000. During that plan year, the 1992 Benefit Plan provided medical benefits to beneficiaries in the amount of \$9,783,000, of which \$2,126,000 was covered by Medicare and DOL (black lung) payments.

DELINOUENCY COLLECTION

As required by the Employee Retirement Income Security Act of 1974 (ERISA), the Funds maintains a systematic, diligent, program to collect delinquent contributions. This program is designed to take appropriate action to pursue every delinquency until contributions are not collectible after diligent effort, due to insolvency and shutdown of the employer, including all jointly and severally liable entities. While the coal industry includes a number of large, financially stable employers, it also includes any small employers who often commence operations and then cease after a few years, (and sometimes after only a few months) due to adverse business conditions or adverse mining conditions. Such employers are often undercapitalized and often become delinquent in their contributions prior to cessation of operations.

Thus, bankruptcies are common in the coal industry, primarily because of its competitive nature. Since the enactment of the Coal Act, the number of bankruptcy filings appears to be trending slightly downward. The number of bankruptcy cases involving the Funds averaged 51 new filings annually in the ten years prior to the Coal Act, and averaged 44 new filings annually in the five years prior to the Coal Act, and numbered 36 new filings in the year after the Coal Act became effective. The frequency of bankruptcy poses a special challenge to the Funds' collection program. The Funds has met this challenge by maintaining a professional audit staff, located in the field service offices, that perform regular audits of signatory employers, and a staff of delinquency and withdrawal liability lawyers and paralegals, assisted by local counsel in firms specializing in this practice in coal field locations. The Funds' auditors and legal staff have developed expertise in pursuing those employers who seek to evade their contribution obligations. During the five years prior to the Coal Act, the Funds delinquency collection program collected over fifty million dollars for all of the Trusts, with the lions' share of this amount recovered to the 1950 and 1974 Benefit Trusts.

Under the Coal Act, the Combined Fund beneficiaries have been assigned to 688 different assigned operators. These 688 operators can be identified to approximately 520 different controlled groups of related persons, which we identified in earlier correspondence with the Subcommittee. So far, 215 operators have been relieved of liability as a result of SSA appeal decisions. To date, approximately 91.1% of the assigned premiums have been paid. Of the \$29.9 million of premiums that have not been paid, approximately \$6.3 million is due from a large assigned operator which is in litigation with the Fund and has entered into an escrow-type arrangement with the Fund. An additional \$6.6 million is accounted for by another assigned operator's Chapter 11 bankruptcy proceeding. The Combined Fund has filed proof of claims in this bankruptcy and taken extraordinary steps to protect the assets in the bankruptcy estate from unlawful dissipation. The Combined Fund has obtained one multi-million dollar settlement in another complex bankruptcy, which was also already pending at the time of the passage of the Act, resulting in payment of most of the premiums assigned to the bankruptcy debtor. Most significantly, the Combined Fund has defeated an attempt by one of the largest assigned operators to have its premium obligations discharged through a Chapter 11 bankruptcy proceeding commenced in 1986.

A total of 217 operators were delinquent, as of March 1995. We have sued, filed proofs of claim or commenced settlement negotiations in matters covering approximately 80% of the premiums owed by these operators. We have suits or other actions in preparation for an additional 15% of the premiums owed. The

remaining 5% is owed by numerous small employers who were assigned small numbers of beneficiaries each. Investigation indicates that many of these are out of business or have filed potentially successful appeals from their assignments.

The Coal Act also requires 1988 Last Signatory Operators and related persons to pay an annual prefunding premium to the 1992 Benefit Plan for all eligible and potentially eligible beneficiaries attributable to such operator. At the same time, the Coal Act requires 1988 Last Signatory Operators, Last Signatory Operators and related persons to pay a monthly per beneficiary premium to the UMWA Benefit Plan for each beneficiary receiving benefits from that plan attributable to such operator. We estimate the 1992 Benefit Plan's collection rate for the annual prefunding premium, paid by 1988 agreement operators, is approximately 90%. However, the collection rate for the per beneficiary premiums owed to the 1992 Benefit Plan is only 19%. The low collectibility of the per beneficiary premiums is not surprising, given that the employers that owe such premiums have already failed to meet their obligation to maintain individual employer plans and are most often in bankruptcy or no longer financially viable. Nonetheless, the Funds undertakes all reasonable efforts to pursue collection of the monies owed to the 1992 Benefit Plan, and it has brought actions for injunctions to compel employers who are able to continue their single employer plans, required by section 9711 of the Act, to do so.

Russell U. Crosby
Acting Executive Director

Chairman Johnson. Thank you, Mr. Crosby. Mr. Ladley.

STATEMENT OF JACK LADLEY, PARTNER, CONSULTING ACTUARY ERNST & YOUNG, L.L.P.

Mr. LADLEY. Thank you for the opportunity to speak to this Subcommittee. I am Jack Ladley, a partner of Ernst & Young, L.L.P., and the managing partner of its national actuarial services. I will testify on behalf of the firm.

I have been an actuary for over 25 years. Ernst & Young was engaged by the Board of Trustees of the United Mine Workers of America Combined Benefit Fund, to assist in projecting and reporting on the fund's future revenues and expenses. This was not an audit of the fund that we performed, but rather a series of actuarial projections, 10 years' future results.

We submitted our report to the UMWA Board of Trustees on March 13, 1995, and I will include a copy of that report for the

record.

[The information was not available at the time of printing]

Mr. LADLEY. Projections involving future health care costs are inherently uncertain. In addition, we have found the results in this case are highly sensitive to certain assumptions, most notably trend. For these reasons, Ernst & Young prepared projections under five different future possible scenarios.

The baseline or middle scenario indicates that the fund balance at the end of fiscal year 2004 is projected to be negative \$39 million. However, I would note that fund balances in this projection

prior are positive until the year 2003.

Two alternative scenarios were also projected which focused only on changes to health care cost trend rate. Alternatives 1 and 2, as they were called, to the baseline scenario, assumed that health care costs increased three-quarters of 1 percent per year less rapidly and three-quarters of 1 percent per year more rapidly respectively than the baseline scenario. The first alternative projects the fund balance to remain positive throughout the forecast and to end fiscal year 2004 at \$65 million. That is a positive. The second alternative to the baseline scenario indicates the fund in 2004 will be a negative \$147 million, but that a negative fund balance will first occur in 2002.

In addition, two other scenarios were projected which we termed most pessimistic and most optimistic. In this case, a number of our assumptions were changed, generally portraying situations where either all experience turned out very favorable or all the experience turned out to be quite adverse. The most pessimistic scenario produced a negative fund balance of \$624 million at the end of 10 years and the optimistic scenario produced a positive \$270 million.

It is clear from the summary results that wide swings in fund position can result from assumption changes which are relatively modest over a 10-year future period. The assumptions to which I am referring include population projections, mortality, medical costs, medical trend rates, expenses and investment earnings.

All of the underlying economic and health care assumptions in our report, including trend, are consistent with those in the 1994 Annual Report of the Board of Trustees of the Federal SMI Trust Fund. We believe that this is with an appropriate and actuarial

sound base from which to develop our assumptions.

We believe that in using this base, our resulting trend assumptions are not inconsistent with those typically used to value post-retirement medical benefits, and that the ultimate long-term trend rate through 10 years is reasonable.

There is clearly a plausible range of views as to whether health care costs can continue to grow as a percentage of the GDP. One plausible view is that they will slow down. However, we believe it is plausible that health care costs can continue to grow as a

percentage of the GDP at least for a 10-year period.

Considering all of these factors, we continue to feel that the five projected scenarios we presented in March to the combined fund trustees are reasonable. Other approaches to setting assumptions for projections such as this is are possible within current standards of actuarial practice. Because of the sensitivity of results, such assumption sets may produce different and even more widely varying results.

We understand the GAO will be examining the base and methodology for assumption-setting and performing their own projections for the fund. We expect the GAO may evaluate the appropriateness of one set of functions relative to another.

Thank you for the opportunity to speak to this Committee. I will

be happy to address questions.

[The prepared statement follows:]

TESTIMONY BY Jack Ladley, Partner and Consulting Actuary with Ernst & Young, LLP before the Subcommittee on Oversight House Committee on Ways and Means June 22, 1995.

Madam Chairman, My name is Jack Ladley. I am a Partner of Ernst & Young, LLP (E & Y) and the Managing Partner of its National Actuarial Services Practice. I have been an actuary for 25 years.

E &Y was engaged by the board of trustees of the United Mine Workers of America (UMWA) Combined Benefit Fund (Fund) to assist in projecting and reporting on the fund's future revenues and expenses. Our report analyzes revenues and expenses related to funding the health and death benefits of the approximately 96,400 covered beneficiaries of the Combined Fund. Our work focused on trust fund balances for the ten year period ending in the year 2004. We submitted our report to the UMWA Board of Trustees on March 13, 1995. I would like to include that report with my testimony for the record.

Projections involving future health care costs are inherently uncertain, but projections of balances in the Combined Benefit Fund are even more uncertain because of litigation and appeals which affect the Fund's revenue. In addition, we have found that the results are highly sensitive to certain of the assumptions. For these reasons, E & Y prepared projections under five different future scenarios. These scenarios are intended to illustrate various possible outcomes and also the sensitivity of the outcomes to changes in the assumptions made. It is highly unlikely that actual results for the fund will match those of any of these projections because of the sensitivity of results and the wide range of factors which impact results. Naturally, we sought to establish our assumptions on a sound actuarial footing.

The baseline or middle scenario indicates that the Fund balance at the end of the fiscal year 2004 is projected to be a negative \$39 million. However, I would note that Fund balances in this projection prior are positive until year 2003.

Two alternative scenarios were also projected which focused on changes to the health care cost trend rate assumption only. Alternatives one and two to the baseline scenarios assumed that health care costs would increase 3/4 percent less rapidly and 3/4 percent more rapidly, respectively, than the baseline scenario. Alternative one projects the Fund balance to remain positive throughout the forecast and to end fiscal year 2004 at \$65 million. Alternative two to the baseline scenario indicates the Fund in the year 2004 will be a negative \$147 million, but that a negative Fund balance first occurs in the year 2002.

In addition, two other scenarios were projected, which we termed "most pessimistic" and "most optimistic". A number of assumptions were changed for these scenarios, generally portraying the situations where either all experience was very favorable or all experience was quite adverse. The most pessimistic scenarios produced a negative Fund balance of \$624 million, and the optimistic scenario produced a positive \$270 million.

It is clear wide swings in Fund positions can result from assumption changes which are relatively modest, over a ten year future period.

The assumptions to which I have referred to include, but are not limited to, the following:

- Population Projections
- •Mortality
- •Medical Costs
- •Medical Trend Rates
- •Expenses
- Investment Earnings

Of these assumptions, the trend assumption is the most critical. Since they focus only on trend, alternatives one and two illustrate that Fund balances at the end of ten years are quite sensitive to changes in this assumption. It is necessary to link this assumption not only to the cost of the plan but also in an appropriate way to the income received by the plan. Some of the sources of reimbursement to the Fund are linked to trend assumptions.

All of the underlying economic and health care assumptions in our report, including trend, are consistent with those used in the 1994 Annual Report of the Board of Trustees of the Federal Supplementary Medical Insurance (SMI) Trust Fund. We continue to feel that this is an appropriate and actuarially sound base from which to develop our assumptions. It provides a linkage between the income and outgo of the Fund.

We believe that in using this base, our resulting trend assumptions are not inconsistent with those typically used to value post-retirement medical benefits, and that the ultimate long-term trend rate through ten years is reasonable.

Financial Accounting Standard Board (FASB) Statement 106 computations deal almost exclusively with the portion of retiree health care benefits which are not covered by Medicare, but our trend assumptions reflect a much broader array of benefits. FAS 106 post-retirement health care benefits typically fill in the coinsurance and deductible amounts which Medicare does not pay. These copayments increase more slowly than health care costs for the elderly, generally. For example, the Medicare hospital insurance (part A) deductible, which is indexed, has increased only about 4% per year and the Medicare supplementary medical insurance (part B) deductible, is frozen at the current level of \$100; thus, it would be expected that FASB 106 trend factors would be lower than trend factors for a plan like the UMWA Combined Fund, which is also at risk for the faster growing portions of Medicare benefits.

There is a plausible fange of views as to whether health care costs can continue to grow as a percentage of the GDP. One plausible view is that they will slow down. However, we believe it is plausible that health care costs can continue to grow as a percentage of the GDP, at least for a ten year period.

Considering all of these factors, we continue to feel that the five projected scenarios we presented in March to the UMWA Combined Fund Board of Trustees are reasonable. Other approaches to setting assumptions for projections such as this are certainly possible within standards of actuarial practice. Because of the sensitivity of results, such assumption sets may project different, and even more widely varying results. We understand that the Government Accounting Office (GAO) will be examining the base and methodology for assumption setting, and performing their own projections for this fund. We expect that the pGAO may evaluate the appropriateness of one set of assumptions relative to another.

Thank you for the opportunity to speak before this committee. I will be happy to address any questions you may have.

Chairman JOHNSON. Thank you. Johnson. Mr. Gathers.

STATEMENT OF JEFFREY L. GATHERS, PRINCIPAL, TOWERS PERRIN, CLEVELAND, OHIO; ACCOMPANIED BY DAVID ALLEN, GENERAL COUNSEL, UNITED MINE WORKERS OF AMERICA COMBINED BENEFIT FUND

Mr. GATHERS. Good morning.

My name is Jeff Gathers. I am a fellow in the Society of Actuaries and a member of the American Academy of Actuaries. I am employed as a principal and senior health and welfare actuary in the Cleveland office of Towers, Perrin, Forster and Crosby. This company, Towers Perrin, is a privately owned international firm of actuaries and management consultants.

My testimony describes the results of analyses performed by myself and other Towers Perrin actuaries of the outlook for future balances in the UMWA combined fund for retiree health care benefits. Thank you, Madam Chairman and Members of this Subcommittee, for the opportunity to present this statement today.

Towers Perrin began its analysis of the fund in 1994 by developing a preliminary financial forecasting tool or model to project how the fund's various income and outgo items would behave under alternative future economic scenarios. We most recently documented the results of our initial forecast model in a report dated January 27, 1995. At about the same time the trustees of the fund retained the firm of Ernst & Young to perform similar projections of funds operations.

The chart on your left summarizes the results for three Ernst & Young scenarios and for the January Towers Perrin results. The table compares the projected cumulative surplus at the end of the 2004 fiscal year.

You can see the Towers Perrin baseline had a projected positive balance of just over \$240 million relative to the other numbers referenced by Mr. Ladley.

I would like to comment on the nature of the difference between Towers Perrin's projections of results at the end of the 10-year period and the range of Ernst & Young forecasts. The Towers Perrin and Ernst & Young approaches are similar overall. However, there are distinct differences in several areas involving the demographic changes in the group, fund operations and most notably, the rate of increase in health care costs as measured by both prices, that is the medical CPI, and the trend in total benefit costs.

We subsequently revised the Towers Perrin model to include some new data that Ernst & Young had used and essentially to emulate their approach. We found that if we duplicate all of the Ernst & Young assumptions in our revised model, we were able to reproduce their baseline forecast of a \$39.9 million deficit in 2004.

However, we do not believe it is equally reasonable to use all of the Ernst & Young assumptions. If we adjust our calculations to change the assumptions related to every element except the medical cost trend, the combined effect is to increase the projected surplus from \$240 million to \$289 million relative to the Ernst & Young baseline of negative \$38.9 million. The significant difference between the Towers Perrin and Ernst & Young baseline estimates is thus due to the different assumptions about the trend in medical

benefits cost per beneficiary.

Ernst & Young has based their assumption on a series of annual rates that they describe as consistent with those used in the 1994 annual report of the Board of Trustees of the Federal SMI Trust Fund. It is most notable that these assumed future rates generally increase throughout the 10-year projection period to a maximum of 9.9 percent in 2004.

Past trend patterns do provide one source of information from which to project future health care cost trends. However, current actuarial practice has judged the continuation of high past trend rates indefinitely into the future to be an inappropriate assumption for postretirement benefit projections. Such trends imply ongoing growth in the health care economy that is much faster than the growth in other sectors. As a result, health care's share of the GDP would continue to increase to levels that the rest of the economy could arguably not support.

Towers Perrin has recently surveyed a number of Fortune 400 companies as to the assumptions used to value future postretirement benefits under Financial Accounting Standard No. 106. We found that more than 95 percent of respondents are using a declining trend rate assumption. The median assumption starts at 11

percent in 1995 and grades to 5.5 percent over 8 years.

Towers Perrin's approach for the fund's projection also uses a declining trend assumption. Specifically, our proposed trend assumption uses a basic annual trend rate of 8 percent in 1995 and grades

to an ultimate rate of 4 percent over 8 years.

In addition, we have adjusted the basic trend rate from 8 to 4 percent for the first 2 years of the projection to reflect additional projected savings from the fund's new capitated pharmacy program. Prescription drugs account for more than 60 percent of the fund's net benefit cost.

We have selected rates slightly lower than the 25th percentile of our survey results to reflect the expected ongoing effects of the trustees' comprehensive commitment to cost management in plan administration. These effects are already evident in the plan's results.

The second table shows the sensitivity of the revised Towers Perrin model to the cost trend assumptions across a range of current actuarial practice. All scenarios, including the Towers Perrin revised estimate and the Ernst & Young baseline, have been adjusted to include a 4 percent short-term reduction of the 1995 and 1996 trend rates to adjust for the pharmacy plan phase-in. You can see the range of results on the table here, all of them in the surplus area.

These results demonstrate that a surplus in the combined fund is expected after 10 years under a range of economic assumptions. We believe that the combination of recent results and the cost management approaches being taken by the trustees provide a strong basis for optimism in this period. In our opinion, the fund surplus in 2004 is likely to fall in the range of \$100 to \$300 million, reflecting the current health care environment and the trustees' commitment to cost management.

Thank you for the opportunity to present this testimony.

[The prepared statement follows:]

Congressional Statement of Jeffrey L. Gathers, FSA, MAAA

My name is Jeff Gathers. I am a fellow in the Society of Actuaries, and a member of the American Academy of Actuaries. I am employed as a Principal and senior health and welfare actuary in the Cleveland, Ohio, office of Towers, Perrin, Forster and Crosby, Inc. This company, more commonly known as Towers Perrin, is a privately owned international firm of actuaries and management consultants. About 12 percent of our employees are stockholders — called "Principals" — of the firm. We have been providing retirement plan actuarial services since 1917, when we designed one of the first private pension plans in the United States.

This testimony describes the results of analysis performed by myself and other Towers Perrin actuaries of the outlook for future balances in the UMWA Combined Fund for retiree health care benefits (the Fund). I have prepared this testimony today on behalf of the member companies of The Reachback Tax Relief Coalition. Thank you, Madam Chairman and members of this subcommittee, for the opportunity to present this statement today.

Towers Perrin began its analysis of the Fund in 1994 by developing a financial forecasting tool, or "model," to project how the Fund's various income and outgo items would behave under alternative future economic scenarios. We subsequently updated our model several times as more was learned about the actual financial experience under the Fund and the management approaches adopted by the Fund's trustees. We most recently documented the results of our initial forecast model in a report dated January 27, 1995.

At about the same time, the trustees of the Fund retained the firm of Ernst & Young to perform similar projections of fund operations. Ernst & Young submitted a report on March 13, 1995, which included results under five assumed economic and operating scenarios. The following table summarizes the results for the three principal Ernst & Young scenarios and for the January Towers Perrin results. The table compares the projected cumulative surplus at the end of the 2004 fiscal year (September 30).

Projected Fund Results as of September 30, 2004 (\$ Millions)

Model/Scenario	Cumulative Surplus/(Deficit) as of September 2004	
Ernst & Young - Baseline	(\$38.9)	
Ernst & Young - Most Optimistic	269.8	
Ernst & Young - Most Pessimistic	(624.3)	
Towers Perrin - January Baseline	240.8	

It is also notable that we extended our January projection model for 50 years; by this point, the surplus was projected to reach \$2.6 billion.

In the following paragraphs, I comment on the nature of the difference between Towers Perrin's projections of results at the

end of the ten-year period and the range of Ernst & Young estimates.

Because of the complexity of the Fund's operations, many assumptions are necessary to forecast the results. The Towers Perrin and Ernst & Young approaches are similar overall. However, there are distinct differences in several areas including:

- the distribution of the eligible population between assigned and unassigned beneficiaries
- assumed death rates
- the implications of premium delinquency
- conditions for transfers from the AML fund
- the cost of medical benefits per beneficiary at specific ages
- the rate of increase in health care costs, as measured by both prices (Medical CPI) and the trend in total benefit cost.

For several of these items, assumption differences reflect certain data that were used by Ernst & Young but to which Towers Perrin did not have access until after we had prepared our January report. We have subsequently reviewed most of these data and have modified our forecast model to reflect the new data and to emulate Ernst & Young's approach. If we duplicate all of the Ernst & Young assumptions in our revised model, we can essentially reproduce their baseline forecast of a \$38.9 million deficit in 2004.

However, we do not believe it is equally reasonable to use all of the Ernst & Young assumptions. If we adjust our calculations to change the assumptions related to assigned/unassigned populations, death rates, payment delinquency, AML transfers, initial cost per beneficiary and future Medical CPI — that is, every assumption except the medical cost trend — the combined effect is to increase the projected surplus from \$240.8 million to \$289.4 million, relative to the Ernst & Young baseline of (\$38.9) million.

The significant remaining difference between the Towers Perrin and Ernst & Young estimates is thus due to different assumptions about the "trend" in medical benefits cost per beneficiary. Ernst & Young has based their assumption on a series of annual rates that they describe as "consistent with those used in the 1994 Annual Report of the Board of Trustees of the Federal Supplementary Medical Insurance (SMI) Trust Fund," i.e., the fund through which Medicare Part B benefits are financed. It is most notable that these assumed future rates generally increase throughout the ten-year projection period, to a maximum of 9.9 percent in 2004.

Past trend patterns provide one source of information from which to project future health care cost trends. This notion appears to be the key to the SMI Trustees' and Ernst & Young's approach. However, current actuarial practice has clearly judged the continuation of high past trend rates indefinitely into the future to be an inappropriate assumption for postretirement benefit projections. Such trends imply ongoing growth in the health care economy that is much faster than growth in other sectors. As a result, health care's share of the Gross Domestic Product (GDP) would continue to increase — to levels that the rest of the economy could not support. For example, some projections have shown health care growing from its current 14 percent of GDP share to nearly 25 percent by 2010 if cost trends do not decline.

To confirm current practice in the area of trend assumptions, Towers Perrin has recently surveyed a number of Fortune 400

companies as to the assumptions used to value future postretirement benefits as of the end of their 1994 fiscal years. These assumptions appear in published financial results and are required (by SFAS No. 106) to reflect the employers' best estimates of future events. The reasonableness of the reported results is certified by each company's independent auditors. We found that more than 95 percent of respondents are using a declining trend rate assumption. The median assumption starts at 11 percent in 1995 and grades to 5.5 percent over eight years. The corresponding 25th percentile (relatively optimistic) rates are 9.5 percent grading to 5 percent, and the 75th percentile rates are 12 percent grading to 6 percent. Some employers select assumptions outside this range, when particular circumstances indicate that it is appropriate.

Towers Perrin's approach for the Fund's projection uses a declining trend assumption. Our proposed trend assumption uses a basic annual trend rate of 8 percent in 1995 and grades to an ultimate rate of 4 percent in 2003 (over eight years). We have selected rates that are slightly lower than the 25th percentile assumptions because of the trustees' comprehensive commitment to cost management in plan administration. The effect of this commitment is already evident in the plan's results. As stated in the Ernst & Young report, for example: "In 1993, the plan actually experienced an 8.5% reduction in per capita trend." In addition, we have adjusted the basic trend rate from 8 percent to 4 percent for the first two years of the projection to reflect additional projected savings from the Fund's new capitated pharmacy program. Prescription drugs account for more than 60 percent of the Fund's net benefit cost.

The table below shows the sensitivity of the revised Towers
Perrin model to the cost trend assumption across a range of
current actuarial practice. All scenarios, including the Towers
Perrin revised estimate and the Ernst & Young model, have been
adjusted to include a 4 percent short-term reduction of the 1995
and 1996 trend rates to adjust for the pharmacy plan phase-in.
In addition, we have slightly adjusted the Medical CPI increase
rates from the Ernst & Young assumption in later years to ensure
that the assumed CPI increase for each scenario is less than the
total benefit cost trend in each year.

Effect of Trend Assumptions on Projected Fund Results as of September 30, 2004 (\$ Millions)

Scenario (Initial/Ultimate Trend)	Cumulative Surplus
Survey Median (11.0%/5.5%)	\$157.7
Survey 25th Percentile (9.5%/5.0%)	257.4
Survey 75th Percentile (12.0%/6.0%)	67.9
Towers Perrin Updated Estimate (8%/4%)	289.4
Ernst & Young Baseline (8.1%/9.9%)	179.2

These results demonstrate that a surplus in the Combined Fund is expected after ten years under a range of economic assumptions. We believe that the combination of recent results and the cost management approaches being taken by the trustees provide a strong basis for optimism in this period.

In our opinion, the Fund surplus in 2004 will fall in the range of \$100 to \$300 million, reflecting the current health care environment and the trustees' commitment to cost management. Moreover, we believe that, if health care cost trends have fallen permanently by the early years of the next decade as virtually

all actuarial projections now assume, the outlook for growing surpluses after 2004 increases significantly.

Thank you again for the opportunity to present this statement.

Chairman JOHNSON. Thank you.

I thank the panel for your testimony. I have a couple of questions

that I would like to pursue.

First of all, and all of you can comment, could you briefly describe for the Subcommittee the scope of the benefits that this plan provides?

Perhaps, Mr. Crosby.

Mr. CROSBY. It is a comprehensive set of health benefits including drug, inpatient, outpatient coverage, home health care under certain circumstances. It is quite a comprehensive program of benefits for the retirees with minimum out-of-pocket expenses for the individuals concerned.

Chairman JOHNSON. Dental, vision, home care—

Mr. CROSBY. No dental.

Chairman JOHNSON. When you say minimal out-of-pocket, what do you mean by that?

Mr. CROSBY. There is roughly a family copayment of \$100 a year.

It is relatively small.

Chairman JOHNSON. It is my understanding that these benefits are age 22?

Mr. CROSBY. That is correct.

Chairman JOHNSON. Is it also true that they are available to unmarried grandchildren up to the age of 22?

Mr. CROSBY. When they are living as a dependent in the home, yes.

Chairman JOHNSON. And also parents of the retiree?

Mr. CROSBY. Yes, when living for 1 year or longer in the same

household as a dependent.

Chairman JOHNSON. So, they are broader in scope than most employer benefit plans both in terms of benefits provided and the number of people included in the family unit; would you agree with that?

Mr. Crosby. I think that is an accurate statement.

Chairman JOHNSON. Why is it that the net expenses—this is according to some materials that came from GAO—the premiums billed, and actual per capita reimbursed expenses, between 1993 and 1995 over a 2-year period essentially doubled from \$122 to \$228 million. That seems odd—at the same time the population declined from 109,000, roughly, to about 97,000. Is there any explanation for that?

Mr. CROSBY. I do not believe those figures are accurate. That

doesn't strike me as correct.

Chairman JOHNSON. You are welcome to submit figures to us on what the net expenses were, because the figures that we have raised a lot of questions.

Mr. CROSBY. That is for the period 1993 through—

Chairman JOHNSON. 1993 to 1995. You mentioned in your testimony that Medicare recipients were about 95 percent of your population; is that correct?

Mr. CROSBY. No, they are about 90 percent of the population.

Chairman JOHNSON. In 1993 and 1994, gross medical expenses were—the figures do not really matter—the Medicare payments were only about 50 percent of that. Now, that does surprise me. When 90 percent of your people are covered by Medicare, I would

expect that Medicare reimbursements would cover more than 50 percent of your gross medical expenses.

Mr. CROSBY. Almost 60 percent of our net benefits are in drugs, which are not covered through Medicare.

Chairman JOHNSON. Do you use any of the companies that are out there in the market that manage drug benefits?

Mr. CROSBY. Absolutely. We have a contract with Diversified Pharmaceutical Services and it is a capitated arrangement so that we pay them a flat fee each year under a 2-year agreement that will be renegotiated at the end of 2 years.

We pay them a flat fee and then they are responsible beyond

that for the actual costs incurred.

Chairman Johnson. What impact has that had on your costs?

Mr. CROSBY. That program started in January, so it is early to tell.

Chairman JOHNSON. Last, does your organization support moving from a per-ton basis for figuring the employer obligation to a per-hour basis?

Mr. CROSBY. We have no input into the negotiations between the

union and the Bituminous Coal Operators Association.

Chairman JOHNSON. Thank you.

I would yield to my colleague, Mr. Herger.

Mr. HERGER. Thank you, Madam Chair.

Maybe a question for you, Mr. Gathers. In reviewing reports, it appears that Ernst & Young used actual fiscal year 1994 and first quarter fiscal year 1995 fund expense data for your analysis. On the other hand, the Towers Perrin model appears to be based largely on fiscal year 1993 actual data. Using fiscal year 1993 data requires Towers Perrin to adjust your estimate to reflect the changes in the Medicare reimbursement rate in fiscal year 1994 and 1995.

My question is, do you feel that fiscal year 1995 estimates of the funds deficit or surplus—to what extent does a difference in the projections result from the fiscal year 1993 base year data used as

a starting point?

Mr. GATHERS. If I understand the question correctly, I think that the difference in the starting data or the baseline data was adjusted for as Towers Perrin moved from the initial model that we developed in 1994 to the revised model, which was referenced in my testimony, as having been updated to reflect the same data as Ernst & Young had used.

During the course of that development, that data, though it had not been available to us initially, was made available and we adjusted all of our starting points to be consistent with the Ernst & Young study in fact, so that that would not be a matter of

difference between the two projections.

Mr. HERGER. Do you have any comment also, Mr. Ladley?

Mr. LADLEY. No. I would echo that they have reproduced our model in every regard, I think, but one, perhaps a minor one. They seem to be consistent. I have not studied their approach, though.

Mr. HERGER. Thank you.

Chairman Johnson. Mr. Cardin.

Mr. CARDIN. Thank you, Madam Chairman.

I am concerned about trying to figure what the fund balances will be based upon, the projections that you have made, understanding of course that we are looking at this with the benefit levels remaining constant and out-of-pocket costs to beneficiaries remaining constant.

Mr. Gathers, you are suggesting that you believe that the appropriate growth level of the cost of the benefits will—should be

phased down to 4 percent? Is that what your model does?

Mr. GATHERS. That is correct. The baseline trend assumption starts at 8 percent at the beginning of this period and gradually reduces over the 10-year period, so that in the last year of the projection the trend rate for benefit costs is 4 percent, while the assumed trend rate for medical price increases is 3.5.

Mr. CARDIN. Half a percent above the market basket for general products. You base that on the fact that there would be no diminution of benefits to the beneficiaries; this is strictly holding down the

cost of services?

Mr. GATHERS. There is no expectation of pulling down the cost of services. As we say, these are positive trend rates going forward. There are no negative trend rates anticipated.

Mr. CARDIN. Do you have any historical data to reflect that any large health care plan has been able to sustain a growth rate as

low as 4 percent?

Mr. GATHERS. Over a long term in the past, that has not taken place, but we need to be cautious not to be so reliant on what has happened in the past that we overlook very likely outcomes that are different in the future.

Mr. CARDIN. There have been many innovative approaches that have been taken to health care that have worked, that have

brought down the health care costs. I understand that.

What we have not been able to demonstrate, unless you have information that I am not aware of, is any sustained effort to keep the growth rate at 4 percent or anywhere close to that over a sustained period of time. We have seen 1 year progress through innovative approaches where growth rate was held well below 4 percent, but we have not seen any, that I know of, any program where they have had a sustained lower growth rate anywhere close to what you are suggesting we should be using to plan the fund balances.

I read an article very recently from a periodical that used the same arguments that you used in projecting health care costs, saying that our society wouldn't tolerate an ever-growing share of the gross national product in health care and that there were innovative approaches being taken and that we must get the growth rate down to the levels that you are talking about. The problem was that article was written in the sixties.

What hope can you give me that we can sustain, without costshifting, that we can bring down the health care costs to that level? Is there something out there that I am not aware of?

Have there been some programs that have successful in doing this? How did you plan a model that you get down to 4 percent?

Mr. GATHERS. The principles of managed care have demonstrated that they are able to produce slower rates of increase across the board than unmanaged care arrangements and I think the notion that at some point the citizens of this country will not put up with chain reductions in their standard of living as we go from \$1 in \$7

being used for health care benefits to \$1 in \$4-

Mr. CARDIN. If I could get me some documentation for that, this Committee would be very grateful. I have seen one-time savings and short-term savings. I have not seen long trend lines of projected savings on the managed care programs.

If you can provide this Committee with some documentation to support that statement, it would be very helpful because, to my

knowledge, we do not have that to date.

We had a group of business leaders in health care reform before this Committee not long ago looking at innovative ways in which health care plans' costs had been brought down within large business plans. At that time I made an offer to the business people there whether they would take over the Medicare system at a growth rate of 3.9 percent adjusted for the demographics.

We did not have any takers that would take over our plans at a 3.9-percent growth rate; yet you are using as your projection a 4-percent growth rate in a similar population group where most are

eligible for Medicare.

I would like you to supply the Committee with documentation to

support a 4-percent growth rate.

[The information was not available at the time of printing]

Mr. Gathers. As I mentioned, it is not possible to document expectations for the future. We do have as documentation the survey of what prevailing actuarial practice provides. These are not just my own assumptions; these are not just Towers Perrin assumptions, but these are assumptions practicing actuaries use to evaluate postretirement benefit commitments for private employer plans throughout the country. The results of that survey information is included in my testimony and referenced in this table.

Mr. CARDIN. Because many of those plans are in trouble today.

Mr. GATHERS. I do not understand that reference.

Mr. CARDIN. Insolvencies, these plans are in jeopardy.

Mr. GATHERS. These are projections of future benefits, not with reference to the actual financing of the plans. These are obligations of the companies that are recognized on their balance sheets and the basis for that recognition is certified by the auditors for these companies.

Mr. CARDIN. Just document for us the results where we have

been able to achieve that. I would appreciate it.

[The information was not available at the time of printing]

Chairman JOHNSON. Thank you, Mr. Cardin.

I would like to just pursue Mr. Cardin's comment about what information, Mr. Gathers, you might be helpful in getting back to the Committee.

Since this plan has so much of its money going out into prescription drugs as opposed to overall health care growth rates, which we hope we will bring down in Medicare due to reform efforts that we intend to make in Medicare, I think very significant to your projections is what savings you might project from better managing the prescription drug benefit and that your expectations in that area could be very useful to us.

Thank you.

Mr. Hancock.

Mr. HANCOCK. Thank you.

Mr. Crosby, I am sure you recall that the Committee on Ways and Means in the House did not play a very significant role in developing the 1992 coal act. Can you tell the Subcommittee why it was necessary to establish two separate funds, the combined fund and the 1992 UMWA Benefit Plan, to provide health benefits to participants, rather than only one plan?

Mr. CROSBY. Basically, they involve cutoff dates of when people were eligible so that the combined fund was sealed as of one date and then there was another date for when eligibility began under

the 1992 plan-

Mr. HANCOCK. Is the plan administered by the same people with the same overhead or is it set up with a separate staff?

Mr. CROSBY. No. It is all handled out of the UMWA Health and

Retirement Fund staff.

Mr. HANCOCK. In other words, there is one set of overhead that covers the entire plan?

Mr. CROSBY. Yes; and several other plans as well.

Mr. HANCOCK. In your testimony you mention there is, roughly, \$29.9 million in delinquent premiums, and you have indicated that you are actively pursuing \$12.9 million of that. What is the situation on the other \$17 million?

Mr. CROSBY. What I said was that, roughly, \$13 million of it was reflected in just two companies, one of which has established a \$6 million escrow. Regarding the other delinquent cases, roughly, 95 percent of those delinquent amounts are now being worked either through bankruptcy court filing, proofs of claim, or other kinds of

legal actions to pursue those other employers.

There are, roughly, 5 percent that involve very small companies with limited numbers of beneficiaries who have been assigned where we have not yet pursued those. In some cases, it simply is not going to be cost beneficial to pursue some of the very small cases where it costs us a minimum of \$4,000 to file an uncontested claim and do the necessary research to pursue a claim that might well be smaller than that amount.

Mr. HANCOCK. Have these delinquencies been referred to the

IRS?

Mr. CROSBY. They have not at this point, because the SSA is still in process of handling appeals and moving assignments between companies and between the assigned pool and the unassigned pool. It simply does not make sense at this time to refer those cases to the IRS until that stabilizes.

Mr. HANCOCK. Do you know of any companies, in your judgment,

that can afford to pay and have chosen not to pay?

Mr. CROSBY. It is usually not a matter of cannot afford to pay or do not want to pay; if there is nothing out there, the company is no longer in business, the mail is returned—

Mr. HANCOCK. Companies that can afford to pay but, have

decided they are not going to.

Mr. CROSBY. I am not aware of any like that. We are pursuing all who can afford to pay through the legal process and the collection process.

Mr. HANCOCK. Getting to another area, our figures indicate that only 28 percent of the entire beneficiary pool are actually retired coal miners. The other 72 percent are surviving spouses and spouses of the miners and dependent adults.

Let me ask you a question about your plan. In the event of the death of a retired coal miner surviving spouse, can that include

more than one spouse?

Mr. CROSBY. Not at any one time.

Mr. HANCOCK. What about situations where there are two, a spouse and an exspouse, and both are drawing Social Security under that one name? In the event of the miner's death and the spouse's death, are the dependent children still covered under the

plan?

Mr. CROSBY. I believe they are. Our plan is not at the discretion of our trustees. The plan was negotiated between the UMWA and the Bituminous Coal Operators Association over a period of years and in fact the union opted for reductions or not to have additional income either through their pensions or current income in order to have lifetime health benefits. That is what they negotiated over the years. Our trustees are presented with the results of those negotiations and do not have discretion to modify the plans.

Mr. HANCOCK. Do you know of other plans that give lifetime benefits both to the employee and the surviving spouses?

Mr. Crossy. I wouldn't have any information on that.

Mr. HANCOCK. OK. You understand, we are still concerned about guaranteeing the integrity of this benefit plan, getting back to the question of who is responsible to fund it.

Mr. CROSBY. It is important to note that the plan was negotiated between the union and the companies. This legislation simply froze that in time to say that the benefits that were in place as of the

date are the benefits to be provided.

Mr. HANCOCK. I understand that, Mr. Crosby, and that is part of the problem. If in fact this was negotiated between the companies and the union, how come the SSA is having to spend millions of dollars administering it—why are the taxpayers putting up this money?

Mr. CROSBY. That was the wisdom of Congress. Mr. HANCOCK. You might have a very valid point.

We have got a declining enrollment in this, I would think. What

is the projection? Are we talking about 2045?

Mr. CROSBY. They are dying at the rate of, roughly, 6 percent a year, and you can pick a point in time and it is—from today, each year, roughly, 6 percent of this population dies. That is why when you look back at the original record on how many beneficiaries were to be covered by this plan, we are down to 92,000 today because after 3 years we have had substantial deaths in this population and they continue to die. The average age is 73. They are very old.

Mr. HANCOCK. One final question for Mr. Ladley. Your analysis on the combined fund—this gets back to Mr. Cardin's question—used a medical cost trend assumption rate as high as 9.9 percent on the outyears. I understand that is roughly twice the rate that you are using for other audit clients in their estimated liability or

funding obligations for their health care benefits.

Can you explain why the differential there between 9.9 and roughly half of what you are using for other of your audit clients?

Mr. LADLEY. The rate that you are referring to, that is much lower, is being used generally for Financial Accounting Standards Board analyses according to statement 106. Those computations deal with postretirement medical benefits typically for corporate plans. They deal almost exclusively with the portion of retiree health care benefits which are not covered by Medicare, filling in the gaps. That is not entirely but generally true.

Our trend assumptions reflect a different mix of benefits. This plan covers a variety of Medicare benefits, not just the gaps in Medicare. For example, the Medicare hospital insurance part A deductible which is indexed has increased only about 4 percent a year and the Medicare supplementary medical insurance part B deductible is frozen at a level of \$100. Therefore, it would be expected that the kind of rates that we are using in this projection and for this purpose would be different from the trends rates in FAS 106. The rates that we did select were chosen according to what I would call our assumption base, which is the SMI 1994 report, and that was adjusted for the specifics of this population. We think it forms an appropriate base.

Mr. HANCOCK. Do you agree with that, Mr. Gathers?

Mr. GATHERS. I believe I understand the distinction that Mr. Ladley is making, but I believe he overstates the differences in expected trends that would come from this distinction. Certainly in my experience in working with the valuation of employer obligations, I find that they have many of the same elements and that they are not just focused on the part A and part B deductibles, as he may suggest. They, in fact, cover a broad range of benefits for retired participants who have not yet reached Medicare eligibility.

Many of our clients, and I suspect Mr. Ladley's as well, have upward of 40 or 50 percent of the future benefits they are valuing for non-Medicare eligible participants. They also very commonly provide prescription drug programs, perhaps not as generous as the UMWA Fund Benefit Plan, but still in some cases quite expensive and accounting, as in the UMWA case, for more than half of the

benefit cost for participants over age 65.

It is also true that the UMWA Combined Benefit Fund is experiencing the same benefit of the low rate of increase relative to the part A copayment amounts for hospitalization benefits under Medicare. So, my sense is, and in fact as we approach FAS 106 valuations, it is our general strategy to look at the gross benefit costs and to recognize the effect of Medicare as an offset much as he is describing is going on in the combined fund. So, I believe that there is a minor distinction, not a substantive difference, that would account for the difference in outlook for long-term trend.

Mr. HANCOCK. Thank you, Madam Chairman.

Chairman JOHNSON. Mr. Portman.

Mr. PORTMAN. Thank you. Thank you all for being here.

Let me follow up with the final question.

It seems to me that one of the assumptions that has not been discussed and that one must make is the degree to which having a population that has an average age of 73, and I think 74 percent

of the beneficiaries are over the age of 70, that there would be certain health care cost differences between that population group and a group of younger workers. Has that been taken into account,

Mr. Gathers, in the analysis as to the percentage?

Mr. GATHERS. Yes. I think that there is another element which contributes to the year-to-year increase in the cost per beneficiary in this program or in other private programs, and that is to the extent the average age of the population is increasing, then that further increases the cost per capita, but that is not something that the methodology for the projection models includes with the trend. Rather, it is a separate element that recognizes that as any of the beneficiaries grows older, they will have costs at a higher rate than they would have at a younger age. I think that is recognized outside the scope of the trend rate.

Mr. PORTMAN. Mr. Ladley, do you have a comment?

Mr. LADLEY. Our report takes a similar approach with the actuarial model. In starting with the SMI base we actually remove any built-in aging factor that might be in there. So, we have it adjusted. We turn around and apply the resulting trend factor to the population projection, which would automatically adjust for the age differentials as this group moves forward. It is incorporated, and recognized there.

Mr. PORTMAN. The other major assumption I would think that would affect that would be the 6 percent figure, whatever the death rate might be and how that is actuarially figured. I would assume the 6-percent increases, given that we have 74 percent of the beneficiaries over the age of 70.

I guess my conclusion from listening to the testimony and reading as much as I have been able to is that this is a relatively fluid situation. There is likely to be some surplus. What it is is hard to tell.

I would think given that 60 percent of the funds are currently being used in the pharmaceutical drug area for prescription drugs, that whatever arrangement you have with Diversified should be monitored closely by this Subcommittee. I hope you will get back to us.

To the extent that the capitation program could reduce costs, I think that might be as significant as the Medicare capitation, working the other way. I just would hope that we could get a better record of that. Apparently, that is just since January?

Mr. CROSBY. Correct.

Mr. Portman. Given the aging population, given the emphasis on drugs, I would hope that we could get a better handle on this over the course of the next few months so that we can have a better sense of this. Having listened to the testimony, I am not sure that I have a good sense of where we are going to end up. I think it is a relatively fluid situation.

Any comments on that? Would you agree with that summary or am I missing something?

Mr. GATHERS. It sounds appropriate to me.

Mr. PORTMAN. Mr. Crosby, any thoughts on that?

Mr. CROSBY. I think you are correct.

Mr. PORTMAN. I yield back. I look forward to hearing from the companies that are present. I appreciate your giving us all this data.

Chairman JOHNSON. Would you provide us with information on your 6-month experience in the prescription drug area, Mr. Crosby. I would like to alert the panelists that we will be sending you some additional questions in writing. I would like Mr. Crosby, for the purposes of the Committee, if you could just explain to us why there are two funds?

This Committee was not a part of developing this legislation, as you may recall, and it is not clear to me why you have to have the combined fund and the 1992 UMWA Benefit Plan Fund to provide benefits instead of one fund?

Mr. CROSBY. The trustees do not participate in the legislative

process either, so-

Chairman JOHNSON. All right. I will try that question later on. Could you briefly tell me whether or not you have received any amounts as a result of the evergreen litigation, and if not, what kind of revenue you expect to receive from that source?

Mr. CROSBY. Actually, I have with me our general counsel who

can address-

Chairman JOHNSON. That would be fine. If you will state your name for the record.

Mr. ALLEN. I am David Allen. I am the fund's general counsel. The evergreen litigation was commenced in 1988. At this time, there have been some substantial settlements in the litigation. Litigation against those who have not settled is still pending in the district court here after a court of appeals decision, and has been referred to a mediator. Negotiations are underway. It would be at this time impossible and indeed inappropriate to comment on any likely outcome of that process.

Chairman JOHNSON. Thank you.

Mr. CROSBY. Madam Chair, you had asked earlier about net assets or net expenses changing between the first and second plan years. While I was sitting here, it dawned on me what you are looking at is the first plan year was an 8-month year. It was not a 12-month year.

Chairman JOHNSON. In 1993?

Mr. CROSBY. Yes. Fiscal year 1993 was a transition year that ran for 8 months. That is the only explanation on why you are seeing a dramatic increase in net expenses. In fact there have been only two plan years since the act came into effect.

Chairman JOHNSON. That is helpful. However, the increase from 1993 to 1994 is from \$122 to \$177 million, roughly \$50 million, and

from 1994 to 1995, it is \$177 to \$228 million.

Mr. CROSBY. We are not in 1995 yet.

Chairman JOHNSON. That is projected on the basis of your

experience at this point. Thank you very much.

I thank the panel and call the next panel. In the next panel we will hear from Clifford Miercort, the North American Coal Corp.; John Faltis, Anker Energy Corp.; Jim Chenoweth, Lone Star Steel; John Patton, Davon Inc., Alan Law, Mountain Laurel Resources Co.

I would like to particularly welcome Lone Star and North American. Sam Johnson, an esteemed colleague, is tied up in a markup today.

Mr. Miercort, please proceed.

STATEMENT OF CLIFFORD R. MIERCORT, PRESIDENT AND CEO, NORTH AMERICAN COAL CORP., DALLAS, TEXAS

Mr. MIERCORT. I am Cliff Miercort, the president and chief executive officer of the North American Coal Corp. I appear here today with representatives of eight other reach-back companies and we represent some 307 companies who are currently being billed for reach-back premiums mandated by the coal act, also known as the Rockefeller Act.

Each of us has a different story to tell of injury inflicted upon our companies, and in many cases upon our personal lives as well by this arbitrary, retroactive tax. Even though currently making a profit, the tax of the Rockefeller Act has imposed a tremendous burden upon us. To put it into perspective in 1992 we wrote off \$110 million to cover the new liabilities imposed on us by this tax.

This writeoff is more than 70 times the average annual profit we ever made from the mines that employed UMWA personnel. The story is set forth in more detail in my prepared statement which

I ask permission to submit for the record.

In the few minutes I have this morning I would like first to review how Congress was induced, maybe a better description would be to say deceived, into passing this retroactive and unprecedented legislative rewrite of prior collective bargaining agreements, and then to discuss the financial dimension of the reach-back tax, and finally to suggest a couple of approaches to fix the problem.

In early 1988, during negotiations for a new wage agreement, the executive committee of the BCOA, Bituminous Coal Operators Association, told the UMWA, United Mine Workers of America, that they were prepared to walk away from their responsibility to

fund the health benefits of UMWA retirees.

By using this threat, the BCOA was able to force a fundamental change in the 1988 wage agreement that was eventually signed. Previously, both pension and health benefits for UMWA retirees had been financed on a pay-as-you-go basis primarily on a per-ton charge for the production of each signatory company.

As shown on the chart on your left, the total contributions to the benefit and pension funds for 1987, which is the column on the far left, totaled \$640 million. That was for 1987, which was the last

year of the 1984 wage agreement.

The 1988 agreement changed the funding formula to entirely a charge per hour for the signatory company and a lower unit amount as well. This resulted in a contribution of only \$255.5 million in 1989, as shown on the next column, a reduction of nearly \$385 million per year or approximately \$1.30 per ton of bituminous coal produced.

To their credit, the UMWA leadership was concerned that the reduced level of contribution would put the benefit funds into jeopardy. However, the negotiating Committee of the BCOA said that they would agree to guarantee the costs which would require the

BCOA signatory companies to increase the level of funding if it were required to keep the funds solvent.

Later, in a comprehensive review of the situation, a Federal District Court confirmed that the BCOA had deliberately set its health fund contribution at a minimal rate in the face of clear indications that it would result in underfunding. Unfortunately, in 1992, when the day came that the benefit funds were running out of money, the BCOA refused to honor their contractual commitment. Instead they sought to perpetuate their self-generated funding crisis until finally a Federal District Court ordered them to honor their guarantee to keep the fund solvent.

It is clear that the so-called funding crisis was entirely manufactured and manipulated by the BCOA so as to create a climate of panic with which they hoped to impact the legislative process. Then they were successful in getting the UMWA to join them in an effort to force a legislative solution.

The documents that were produced in the Pittston versus the UMWA litigation in Abingdon demonstrate the cynical record of cooperation between the UMWA and the BCOA and the deliberate creation of fear among the retirees to produce the passage of the Rockefeller Act.

The Lobbying Act reports show that the BCOA and the UMWA spent \$3 million in their efforts to achieve the economic bonanza of the Rockefeller Act. As shown on this chart, it was money very well spent.

The passage of the Rockefeller Act resulted in a further reduction of \$132 million in the amount the companies who signed the BCOA agreement had to pay into the fund. This is the level of savings the head of the BCOA boasted to members they would receive from the passage of the act. When you add that amount to the amount that the BCOA saved from the 1988 agreement, you get the column that says \$516.8 million. That was their total savings per year from what they had been paying in 1987.

At the same time, the act put a tax of \$52.7 million on reachback companies, who had been out of the business of mining bituminous coal for 10, 20, 30 and in some cases 40 years. That is shown on the column on the right side of the chart.

It is instructive to review how much the funds were in a deficit position during the period of 1988 to 1993, the deficit that BCOA made into a supposed national crisis. The average deficit was only \$10,800,000 per year. Thus, the true issue was not a financial crisis of the funds, but rather how much the BCOA could take from someone else, primarily the reach-back companies who, unfortunately, did not have the same political clout they did.

What can Congress do to fix this terrible inequity? The reachback companies currently pay the combined fund about \$53 million per year, which is only 10 percent of the yearly savings that have been realized by the BCOA companies. One partial solution is H.R. 1370, the Myers-Hancock bill, which would dedicate any surplus in the funds above a safety cushion to credit against reach-back company premiums. This bill would alleviate the reach-back as long as there is a surplus in the funds. Because of this, it is not a complete fix to the problem.

We believe based on the combined fund statements from March 1995 that there is at least a surplus of \$221 million on a cash basis

and a \$147 million surplus on an accrual basis.

Another solution would be to remove the reach-back portion of the act entirely. As the chart reflects, a complete replacement of the reach-back payments by the current signatories would require the giving up of only \$53 million, which is 21 cents per ton of their previously realized yearly savings of \$1.83 per ton. This would put the responsibility for retiree benefits back onto the signatory companies, where they had always been prior to the Rockefeller Act. It would get the government out of enforcing an obvious unfair

It would get the government out of enforcing an obvious unfair and discriminatory law. It would place the cost of collective bargaining on the parties who negotiated the agreements, where it has always belonged. This system works for everyone else in

America. Why not for the bituminous coal industry?

Thank you.

[The prepared statement follows]:

CONGRESSIONAL STATEMENT OF CLIFFORD MIERCORT

It has frankly not been much fun at times to be the CEO of North American these past three years since the Rockefeller Coal Act was passed. My company has been accused by various adherents of the bill of a failure of corporate citizenship and worse. I am grateful to you and the committee for the opportunity to set the record straight.

First, as I am confident will be demonstrated by the record of this hearing, it is increasingly clear that passage of the Rockefeller Act with its attendant infliction of pain on a host of American companies was entirely unnecessary. The records of the Fund itself demonstrates that the only funding crisis was one deliberately induced by the BCOA through its change in the rate and method of contribution to the Funds from per ton to a per hours worked basis, producing a deliberate under-funding of the both the 1950 and 1974 health benefits fund by 1992.

Second, the Rockefeller Act has unilaterally transferred the hitherto unquestioned responsibility of the current 1988 signatory operators to meet the entire liability of the 1950 and 1974 Funds on a pay-as you-go basis to a combination of the reachback companies, the coal industry generally, and the 1988 signatories through mandatory contributions to the Combined Fund created by the Act. This has created a wealth transfer to the BCOA companies estimated by at least two sources at more than \$130 million a year and the legalized confiscation of approximately \$50 million annually from the reachback companies. The amount of this windfall was confirmed in February 1993 in a letter from the President of the BCOA to his members. This kind of legislative restructuring of collective bargaining arrangements is unprecedented in American history and can only be explained as the outcome of a highly cynical and sophisticated political lobbying campaign which carefully concealed from the Congress the purpose and the effect of what it was being asked to do. No one can believe that any legislator would willingly create the kind of economic and psychological damage which has been described here today.

Third, North American has been falsely accused of hiding behind smaller reachback companies in its expressing its outrage over the unprincipled, but painstakingly crafted economic rape of the reachback companies produced by the Rockefeller bill. The truth is that the BCOA companies have been and continue to hide behind North American in an effort to justify the legalized theft of reachback company assets produced by the Coal Act. Let me explain.

Historically, as companies chose not to participate in subsequent Bituminous Coal Wage Agreements, the remaining signatory companies continued to cover the costs of retirees who had worked for others. New companies who entered the business and signed a Bituminous Coal Wage Agreement paid into the Funds on the same basis as companies who had been in the business for a long time, even though they may have yet not had any retirees. This approach was the core concept behind the multi-employer retiree health benefits system. In fact, during the 34 years that North American Coal contributed to the Funds, we paid millions of dollars for benefits to orphan miners from other companies that had gone out of business or elected not to sign a new Bituminous Coal Wage Agreement. In addition, when we left the business in 1984, the Funds were fully solvent.

In 1978 the BCOA agreed to change in a fundamental way the method of providing health care to current employees and subsequent retirees. In order to end two decades of perceived waste and abuse by the funds, each company would henceforth run its own health benefits program to provide the level of benefits established by the current NCBWA. The 1974 Health Benefits Fund was preserved at the insistence of the UMWA to be an explicit multi-employer safety net to provide health benefits to those who retired after 1975 when the 1950 fund was closed and whose employer ceased to be

a NCBWA signatory. By the mid-1980's several companies left the ranks of NCBWA signatories and successfully established through clear judicial precedent (over the opposition of the BCOA and the UMWA) that they had no continuing liability for payments to the funds and that their retirees were entitled to receive benefits from the 1974 fund. North American left the bituminous coal industry in 1984.

Since that time the BCOA has hidden behind us and the other reachback companies to justify:

- the false statement that a financial crisis existed that would bankrupt the funds because the BCOA could not afford to meet its clear contractual commitments;
- the false statement that legislation was needed to prevent future withdrawals from the NCBWA when withdrawal liability had already been established by the 1988 NCBWA; and
- the confiscation of reachback company assets to relieve BCOA companies of a large share of liability for 1950 and 1974 Fund retirees.

The unconscionable nature of the wealth transfer to the already rich BCOA companies engineered by the Rockefeller Act is difficult to overstate.

A final reason why the Coal Act is particularly unfair to North American Coal is that there is no mechanism for passing on to our customers any of these retroactive assessments. Under the terms of our sales contracts, our customers had the obligation to pay for all costs of our employee benefits. When we made the business decision to leave the bituminous coal industry, we made every effort to assure that North American Coal had fulfilled all of its multi-employer benefit obligations, and to ensure that these obligations were paid by our customers as provided for in our contracts. We relied on the clear and unambiguous language of the Wage Agreement, in making this judgment. Our interpretation of this language has been confirmed by several federal court decisions. Had we any way of knowing that new benefits obligations would be imposed on us retroactively, many years after leaving the bituminous coal business, we would have included such costs in the closing that would have been paid by our customers. Our customers, had they been advised of these costs, would have been fully prepared to pay them. As you can well understand, with the complete closure of all of our bituminous coal mines, we no longer have the ability to pass along the reachback assessments to our former customers for whom we mined the bituminous coal in question. For us there is no Rockefeller Act to pass these costs backward on a retroactive basis.

The net result of the retroactive re-writing of all of our contractual obligations has been that in 1992 my Company had to take a one-time charge to earnings of \$110,000,000 after tax. To put this amount in perspective, this charge was more than 70 times greater than the average annual profits made by all of North American Coal's bituminous coal mines during the entire 21-year period from 1960 to 1980. However, since 1992, the large BCOA companies have been pocketing over \$130 million each year. This simply is neither right, nor fair.

It is my hope that, as a result of this hearing, your committee (and ultimately the entire Congress) will correct these inequities so that small reachback companies will no longer be pushed to the wall by this law and that you will rectify the extraordinary financial burden on the larger reachback companies. This can be done in such a way that it would not adversely affect the BCOA member companies. Indeed, even if the reachback companies were completely removed from the Rockefeller Act, the BCOA companies would still pay less into the Funds on a per ton basis than the amount we paid when we were a signatory to the Bituminous Coal Wage Agreement. The reachback tax is unfair, it has been held unconstitutional by one Federal court, and needs to be changed. Thank you for your time, Madam Chairman.



THE NORTH AMERICAN COAL CORPORATION

SIGNATURE PLATE II. 14785-PRESTON ROAD. SUITE 1100

CLIFFORD R. MIERCORT President and Chief Executive Officer

July 28, 1995

The Honorable Nancy Johnson House Subcommittee on Oversight 1136 Longworth House Office Building Washington, DC 20515

Dear Chairwoman Johnson:

I appreciated very much the opportunity to provide testimony regarding the "Reachback Tax" issue to the Subcommittee on Oversight of the House Ways and Means Committee. I hope you agree with me that the Reachback Companies offered compelling cases, illustrating that a retroactive tax to pay for health benefits that were never promised by those companies and that reaches back ten, twenty, thirty, and, in some cases, forty years, is totally unfair.

I am pleased to submit answers to the questions raised in your letter to me dated July 10, 1995. My answers are detailed in the enclosure entitled, "Questions for Clifford R. Miercort of The Reachback Company Panel". In addition, I would like to make the following observations and recommendations.

in reading the transcript of the June 22 hearing, I was struck by the inaccuracies that were presented by those who testified on behalf of the United Mine Workers of America (UMWA) and the Bituminous Coal Operators Association (BCOA). One inaccuracy that must be addressed is their assertion that the Reachback Companies promised lifetime medical benefits to their former union employees. This is a baseless contention without factual or legal support. Do you know of any company that would agree to pay for a future liability when they do not know with any certainty the level of benefits or the costs? I know that North American Coal would not and did not do so. The BCOA/UMWA National Wage Agreements that we signed, the last one being in 1984, never obligated us, nor any of the other Reachback Companies, to pay for lifetime medical benefits.

To help you make an informed decision on this matter, I am enclosing a copy of a letter and summary that we sent last year to Mr. Allen Huffman, Tax Counsel for Senator Dorgan, debunking the theory that we and other Reachback Companies promised lifetime medical benefits (also known as the "Evergreen Theory"). In addition, I would call your attention to the detailed analysis, entitled "Who Promised What to Whom When?", already submitted to the Committee by Jonathan C. Rose, partner of Jones, Day, Reavis and Pogue. I am convinced that, after you and your staff analyze these materials, you will concur with me that the "Evergreen Theory" is without merit, and that none of the Reachback Companies promised to provide lifetime benefits.

The other blatant inaccuracy which must be addressed is the false charge that the healthcare of the retirees will somehow be jeopardized by your addressing the Reachback tax issue. The Reachback Companies have not advocated any change in the benefit levels for the retired miners. The UMWA and BCOA representatives continue to make this unfounded and irresponsible accusation to deliberately worry the retirees, so they will become active in opposition to your fixing the problem. The real issue involves not the taking away of any retiree benefits, but deciding which companies should pay for them.

I know as you go forward in your deliberations on this issue that there will be intense opposition from those companies who have unjustifiably benefited by the unfair imposition of retiree healthcare costs on the Reachback Companies. However, the serious and unjust burden imposed on the Reachback Companies by the Coal Act can and must be relieved.

My sense from the hearing was that a number of the Members would prefer legislation that would provide a comprehensive and final solution to the problems faced by the Reachback Companies. As I mentioned in my testimony, a solution would be to remove the Reachback portion of the Act and have the Reachback beneficiaries reassigned.

Thank you for the opportunity to provide this additional information for the official record of the hearing.

Sincerely, Affordk. Whind

Clifford R. Miercort

Chairman JOHNSON. Thank you. Mr. Chenoweth.

STATEMENT OF JIM CHENOWETH, DIRECTOR, CORPORATE AFFAIRS, LONE STAR STEEL CO., DALLAS, TEXAS; ACCOMPANIED BY RHYS BEST, PRESIDENT AND CHIEF EXECUTIVE OFFICER, LONE STAR STEEL CO.

Mr. CHENOWETH. Thank you, Chairman Johnson, for allowing me to come before you this afternoon. I also wanted to introduce the chief executive officer of Lone Star Steel, chief executive officer and president Rhys Best, who is here also and would be able to answer questions should you want to ask them.

I am here to tell you the shocking story of what the coal industry Retiree Health Benefit Act of 1992 has done to Lone Star Steel Co.

and to the good men and women who work there.

Lone Star is a fully integrated steelmill located in northeast Texas. We are able to produce 1 million tons of steel a year and we convert virtually all of that steel either into pipe that is used in oil and gas wells or into tubes used in the automotive industry.

Lone Star was founded during World War II as a defense manufacturer. Coal was a necessity in the steel-making process then, but modern technology changed that long ago. We haven't needed coal at Lone Star since the new electric furnaces replaced the old blast furnaces and open hearth furnaces many years ago. Lone Star ceased coal mining in 1963. In other words, we have not had a coal miner on our payroll since President Clinton was in high school; not in the last 32 years, not one. Had a coal miner retired from Lone Star Steel Co., he would now be 97 years old.

Lone Star Steel has never been a member of the Bituminous Coal Operators Association. Since at least as far back as 1963, we have not signed a coal miners union agreement nor a health care agreement nor pension agreement, not one. That did not seem to matter to Congress when it passed the Coal Industry Health Benefits Act of 1992 and ordered us to begin paying \$69,561 each month to the health care fund. We do not have that kind of money sitting around Lone Star ready to ship to Washington.

We consider what the Congress has done is an illegal taking, unjustly and unnecessarily confiscating our assets without a moral or ethical right, much less a legal right. Already a Federal District Court has held that this act is an illegal taking and is therefore

unconstitutional at this moment.

Our recently retired-Congressman from Texas, Jake Pickle, the past Chairman of this Subcommittee, described the egregiousness of this act better than I could. This is a statement that he made to this Subcommittee in October 1992.

Today the eastern States' coal industry is dominated by foreign-owned companies and about 4 years ago the coal operators decided they were no longer going to live up to their responsibility to pay the health benefit plan, so they reduced their contributions and the plan today faces insolvency.

That was 1992.

Now Congress is being blackmailed into bailing this plan out by taxing companies that have no current connection with the bituminous coal industry. It is as if Congress is a gang mugging an innocent passerby and justifying it by saying, well, our family and friends are hungry. Mr. Pickle's complete comments are attached to our printed testimony and I strongly urge you to read every bit of it.

By deciding to assign this obligation to Lone Star Steel without good reason or logic, the government caused an unanticipated drain on our funds and necessitated the establishment of a \$11 million reserve to cover this imposed liability straight out of cash flow. It was hard, and it hurt us severely. Worst of all, it hurt our people.

These takings represent 40 cents an hour for every one of our active employees. Put another way, these takings add \$2 a ton to our cost of all pipe we ship, and nowadays it means a lot of pipe we do not ship due to being no longer competitive. It is especially true for exports. When it comes to transferring funds to another industry mandated solely by government fiat, we not only cannot afford it, but we are confident that the courts some day will uphold our contention that this 1992 act is illegal and it is unconstitutional.

Thirty-two months ago Congress acted quickly, and in so doing has harmed a class of American businesses now known as reachbacks. This was done with no hearings, no comments, no consideration to the harm done. The act of 1992 is bad legislation at its worst and, again, as Mr. Pickle described it, "I believe that the coal provision is a travesty of justice, an embarrassment to the Congress and we should never let ourselves be put in this corner again."

Now the facts are evident. Will Congress be just as quick to stop our bleeding and heal our wounds? Lone Star Steel asks to be relieved of this undeserved burden of being forced to pay someone

else's bills.

Thank you for the opportunity to plead our case today. [The prepared statement and attachment follow]:

STATEMENT OF JIM CHENOWETH OF LONE STAR STEEL COMPANY

UNITED STATES HOUSE OF REPRESENTATIVES

SUBCOMMITTEE ON OVERSIGHT

Thursday, June 22, 1995

Good morning, Madam Chairwoman. Thank you for this opportunity to tell the shocking story of what the Coal Industry Retiree Health Benefit Act of 1992 has done to Lone Star Steel Company and the good men and women who work there.

Lone Star is a fully integrated steel mill in a town in Northeast Texas of the same name. It's a nice town and we think we have a pretty nice company. We are able to produce a million tons of steel per year. We convert virtually all of our steel either into pipe used in oil and gas wells, or into tubes used in the American industrial equipment, transportation equipment and automotive industries.

Lone Star Steel was founded during World War II as a defense manufacturer. Coal was a necessity in the steel-making process then. But modern technology changed that long ago. We haven't needed coal at Lone Star since new electric furnaces replaced old blast furnaces and open hearth furnaces many years ago.

Lone Star Steel ceased coal mining in 1963 -- when President Clinton was still in high school! Lone Star has not had a coal miner on its payroll in 32 years. Not one.

Lone Star Steel has never been a member of the Bituminous Coal Operators Association. Since at least as far back as 1963, we have not signed a coal miners' union agreement, a health care agreement or a pension agreement. Not one.

That didn't seem to matter to the Congress, however, when it passed the Coal Industry Retiree Health Benefit Act of 1992 and ordered us to begin paying \$69,561.02 per month into this union retiree healthcare fund. Madam Chairwoman, we do not have that kind of money sitting around Lone Star, ready to ship off to Washington. We consider what the Congress has done an illegal taking, unjustly and unnecessarily confiscating our assets without a moral or ethical right, much less a legal right. Already a federal district court has held this act as an illegal taking and is therefore unconstitutional.

Our recently retired Congressman from Texas, Jake Pickle, the past chairman of this subcommittee, described the egregiousness of this act far better than I ever could. Allow me to quote briefly from his statement to this subcommittee in October 1992. (QUOTE)

"Simply put, the mine workers and the bituminous coal operators agreed decades ago to establish a health plan that would be paid for by all who mined coal in the eastern United States. As long as 'coal was king' this agreement worked reasonably well."

Mr. Pickle went on (QUOTE), "Unfortunately, the coal industry changed dramatically. Today, the eastern states' coal industry is dominated by two foreign owned companies. About four years ago the coal operators decided that they were no longer going to live up to their responsibility to pay for the health benefit plan. And so they reduced their contributions, and the plan today faces insolvency."

Then Mr. Pickle emphasized (QUOTE), "Now congress is being blackmailed into bailing this plan out by taxing companies that have no current connection with the bituminous coal industry. It is as if Congress is a gang, mugging an innocent passerby, and justifying it by saying 'Our family and friends are hungry'."

By deciding to assign this obligation to Lone Star Steel without good reason or logic, the government caused an unanticipated drain on our funds, and necessitated the establishment of an \$11 million reserve to cover this imposed liability. It has hurt us and hurt us severely. Worst of all, it has hurt our people. These takings represent 40 cents for every hour worked by our active employees. Also think of the huge ripple effect a 40 cents per hour pay raise would have on the local economy. Put another way, these takings add \$2 per ton to our cost for all pipe we ship. Often it means pipe we don't ship because we no longer are competitive. This is especially true for exports. These takings are threatening our economic viability and severely limiting our global competitiveness.

Now, Mr. Pickle continued, and (QUOTE), "We can all be sympathetic to the plight of the mine workers, but their benefits should be paid by the coal companies, not everyone else. Why are we kow-towing to these huge foreign owned companies? It was their cut throat business practices that drove the domestic coal companies out of business. And now we bail them out? We let them escape their obligations while they ship their profits overseas. We should be ashamed," he told the committee.

Let me further describe how Lone Star Steel has been impacted by this act.

Lone Star Steel Company in 1994 had annual revenues of \$350 million and 1500 employees with approximately half of them members of the United Steel Workers Union. We are leaders in the marketplace of energy industry tubulars and automotive industry tubulars. We have received the "E Star" award for excellence in exporting our products into more than 60 foreign countries.

The energy boom of the 70's ended in a bust in the 80's and Lone Star Steel was forced to cut 5,000 jobs. Revenues dropped from \$1 billion to \$200 million. We finally were driven into Chapter 11 and, in slightly less than two years, Lone Star reorganized. We paid our creditors in cash of 84 cents on the dollar. Now in the 1990's we are slowly recovering. We are paying our bills. Our business has become marginally profitable again. We are investing heavily in environmental protection. We are leader in recycling of ferrous scrap and other materials.

But when it comes to transferring funds to the government due solely by government fiat, we not only cannot afford that, but we are confident the courts will someday uphold our contention that the Coal Industry Retiree Health Benefit Act of 1992 is illegal and unconstitutional.

In a note of prophesy, Mr. Pickle added (QUOTE), "Let me also warn my colleagues, you have not heard the last of this issue. I tell you, we are setting a precedent today that will come back to haunt us. Today, we are bailing out the mine workers' plan, and letting the mine operators have a windfall. Who will be next? Will it be the steel industry? The airlines? Tire and rubber companies? Or perhaps it will be the auto industry?"... Finally, he stated, "I believe that the coal provision is a travesty of justice and an embarrassment to the Congress. We should never let ourselves be put in this corner again."

In October 1992, Mr. Pickle warned this committee that the talk of the fund going under was bogus, and sure enough today we see this fund is awash in cash. The actual fact is that the miners' union did not need the money that was taken from companies like Lone Star Steel.

Why then is Congress forcing us to continue to further bloat the Fund's glutted surpluses?

Another question more basic is why should the Congress even be involved at all in the micro-management of a non-government healthcare fund, directly interfering with a collective bargaining process which was working?

Thirty-two months ago, the Congress acted quickly to severely harm a class of American businesses now known as "Reachbacks". This was done with no hearings, no comments, no consideration to the harm done. The Coal Industry Health Benefit Act of 1992 is bad legislation at its worst. Now that the facts are evident, will Congress please be just as quick to stop our bleeding and heal our wounds? Lone Star Steel asks to be relieved of this undeserved burden of being forced to pay someone else's bills. I thank you for the opportunity to plead our case today.

REMARKS OF CONGRESSMAN J.J. PICKLE BEFORE THE HOUSE WAYS AND MEANS COMMITTEE OCTOBER 5, 1992

Mr. Speaker, I rise today in support of the energy bill. I support this bill because it includes important incentives for solar energy and much needed relief for independent producers who explore and develop energy supplies. And I'm especially pleased about new incentives for expanding our use of alternative fuels, like compressed natural gas. Alternative fuels will not only help curb our imports of petroleum, but will also improve our environment by cutting down on harmful emissions. These are all good, and vital pieces to our national energy strategy.

But there is one part of this bill which is deplorable, and that is the bituminous coal health benefit bailout. Mr. Speaker, this bailout, as well intended as it may be, is a terrible injustice, and sets a precedent in the area of employee benefits that we will all live to regret.

Simply put, the mine workers and the bituminous coal operators agreed decades ago to establish a health plan that would be paid for by all who mined coal in the eastern United States. As long as "coal was king" this agreement worked reasonably well. Unfortunately, the coal industry has changed dramatically. Today the eastern states coal industry is dominated by two foreign owned companies and the number of miners has drastically declined. About four years ago, the coal operators decided that they were no longer going to live up to their responsibility to pay for the health benefit plan. And so they reduced their contributions to the plan, and the plan today faces insolvency. And now the Congress is being blackmailed into bailing this plan out by taxing companies that have no current connection with the bituminous coal industry.

Mr. Speaker, we should not do this! It is wrong! It is as if we are a street gang mugging an innocent passerby, and justifying it by saying that our family and friends are hungy. We should stick to the original agreement and force those companies who are mining eastern coal to meet their obligations. We can all be sympathetic to the plight of the mine workers, many of whom are elderly and in ill health. But these benefits should be paid by the coal companies, not everyone else. Why are we kowtowing to these huge foreign owned coal companies? Why are we raising taxes on domestic energy companies to pad the profits of these foreign profiteers? It was their cut throat business practices that drove the domestic coal companies out of business, and now we bail them out. We let them escape their obligations and ship their profits overseas. We should be asthamed!

Let me also warn my colleagues, you have not heard the last of this issue. We pay for this bailout by taxing any company or its successor which ever had any connection with mining coal under the BCOA agreement. We have no idea who all these companies are. There will now be a rush to track them down and tell them that they will have to pay millions of dollars a year into this health plan over which they have no control. Some will be forced into bankruptcy, others will be forced to lay off workers. And they will blame you and me, and they will be right. So plan today what you will tell them, it won't be easy.

Finally, I tell you that we are setting a precedent today that will come back to haunt us. Today we are bailing out the mine workers plan and letting the mine operators have a windfall. Who will be next? Will it be the steel industry? The airlines? Tire and rubber companies? Perhaps it will be the auto industry? I tell you right now that there is good reason to believe that the steel industry is already making plans to get a similar bailout.

The members should know that our defined benefit pension plans, which are guaranteed by the Pension Benefit Guaranty Corporation, are underfunded by over \$40 billion dollars. Some of the largest companies in America have deliberately chosen to underfund their plans by billions of dollars. And, when I raise this issue no one wants to talk about it. The companies refuse to appear before the Oversight Subcommittee. I am accused of frightening people and undermining confidence in our pension system. I do not want to frighten anybody. But we must insist that companies that make benefit promises keep their promises.

At the same time the other Body was hatching this plan to bail out the coal health plan, it balked at adopting a proposal to make companies properly fund their pension plans. It seems inconvenient to pressure companies to keep their pension promises. There are always a thousand excuses for putting this responsibility off to a later day. But the later day always comes. For the coal industry it comes today and we have chosen to rob Peter to pay Paul. Who will we hijack when the time comes to bail out the rest of our retirement system? Every company that has ever sponsored a pension plan or ever intends to should ask that question. Because today we are telling the world that if you play by the rules and meet your responsibilities you pay the penalty, and the sharp operators who run and hide go free.

Mr. Speaker on balance this is a good bill. It would be better if we had stood our ground and held the coal operators to their own promises. This provision to make other companies pay the coal industry's bills is just a selfish regional request. The other body has caved in to this blackmail by three or four key senators. We can all agree to protect the miners' benefits, but we should have agreed to make the mine owners and operators pay. I, for one, was willing to do so. However, I am not willing to block this entire bill for this one reason. But, I believe that the coal provision is a travesty of justice and an empharrassment to the Congress. We should never let ourselves be put in this comer again.

Chairman JOHNSON. Thank you very much, Mr. Chenoweth. Your testimony is a stark reminder that the words in the pediment of the Supreme Court are indeed difficult to realize. I used to walk to work past the Supreme Court building every day and on the pediment it reads, "equal justice under law." It is very hard to write the law so that there is equal justice and the injustice that is imposed on your company by this law is really appalling.

I am going to yield the chair to my colleague, Mr. Portman from Ohio—he has voted and I have not. I will be back shortly and he will take over. I think hearing from the companies has been very useful to us. We will finish the panel, have questions and then have a short recess before the next panel so those of you serving

on the next panel might want to get a bite of lunch.

Mr. PORTMAN [presiding]. Thank you, gentlemen, and apologies for the inconveniences. I left about 10 minutes ago to offer an amendment on the House floor and I learned that we now have two additional procedural motions before that. I appreciate your patience.

Mr. Faltis.

STATEMENT OF JOHN FALTIS, PRESIDENT, ANKER ENERGY CORP., MORGANTOWN, WEST VIRGINIA

Mr. FALTIS. Distinguished Members of the House Subcommittee, thank you for the opportunity to testify. I am John Faltis, president of Anker Energy Corp. I am here today on my own behalf. I am anxious to tell you about how my company is affected by the Coal Industry Retiree Health Benefit Act, because as it stands, the act unfairly puts Anker Energy at a competitive disadvantage with

large BCOA companies.

It is no coincidence that the large BCOA companies spent a great deal of time and money getting the act passed. There is no question that the miners should receive the retiree health benefits as promised. However, under the act, companies like mine, companies who never promised to pay the benefits, and who never had representatives in a position to affect management of the retiree health funds are now forced to pay for an unfair share of those benefits, while the largest coal companies, the ones who fought so hard to pass this act in the first place, reap huge windfalls.

Anker is a medium-sized, West Virginia-based coal company with offices and operations in Connecticut, Maryland, Kentucky,

Indiana, Oklahoma and Pennsylvania.

We supply our coal to customers in 14 States, including Connecticut, New Jersey, New York, Ohio, Maryland and Missouri. Two of our affiliates had only limited periods of employment under UMWA coal wage agreements.

In both cases the miners were employed for only a fraction of their mining careers. However, the act is forcing Anker to pay full lifetime retiree and dependent health benefits. This is unfair, especially since the BCOA companies we compete with receive a windfall of hundreds of millions of dollars under the act, giving them an unfair advantage in the marketplace.

The bottom line is this act has put at risk my 600 employees and put at risk hundreds of additional contractors and other people

that rely on our business to survive. It has put their job security and their benefits at risk as well.

Anker has been assigned liability under the act two ways. First, 20 years ago, one of Anker's affiliates, King Knob Coal Co., operated as a contract miner for a BCOA member company, one of the largest coal companies in the world. Under the contract mining arrangement, the BCOA company owned the coal reserves and King Knob mined the coal. King Knob is required by the BCOA company to sign a coal wage agreement and use only union workers to mine the coal.

Unlike many contract mining arrangements, it was the BCOA company and not King Knob that was liable to pay the health

benefits for the miners employed at the operation.

In the early eighties, the BCOA company unilaterally terminated its contract with King Knob, causing the layoff of most of the miners. Briefly, King Knob later took over the mine to complete reclamation required by law, rehiring some of the workers for a short period. Under the reach-back provision of the act, Anker will be asked to pay the liability that the large BCOA company dumped on us.

Anker has another very limited relationship with union workers. Over a 6-month period in the late seventies an Anker affiliate purchased the stock of Reliable Coal Co., a small, insolvent UMWA-organized company. Reliable was about to lay off its 200 workers when it became an affiliate of Anker.

Unfortunately, market conditions forced the mine to close after only 6 months and the Reliable miners were laid off. Under the act Anker is solely liable for the lifetime retiree health benefits of the former Reliable miners and their families, as well as a portion of the retiree health benefit costs of unassigned miners.

To bring this inequity into focus, the Reliable miners worked in the mines for more than 20 years. An Anker affiliate employed them for only 6 months, one-fortieth of their work life, but Anker must foot the bill for all in lifetime retiree health benefits and that of their families as well.

Ladies and gentlemen, this amounts to a huge retroactive payment for the few hours these Reliable miners were employed. Clearly this imposes a severe and unfair burden on Anker.

As a result of the act, Anker has been informed by the combined fund that it can anticipate 220 assignees for a one-time cost of \$1.2 million and an annual cost of \$500,000. These are huge costs for my company to bear, especially as they were not bargained for, were not anticipated, and have no relationship to any revenue-producing operation of my company. Again, costs like these jeopardize the jobs of my 600 active employees and the many others that depend on our company.

In closing, I ask you to help my company and its employees by removing the unintended inequities caused by the act and providing for a more evenhanded allocation of retiree health benefit liability. Undoubtedly, proposals such as H.R. 1370 will alleviate some of these burdens, but to be truly fair, these costs must be borne by those BCOA companies that reap the benefits of long-term labor agreements while having market dominance. Action or inaction on this act could mean the difference between survival and insolvency for Anker and many other companies. Thank you.

[The prepared statement follows:]

STATEMENT OF JOHN FALTIS PRESIDENT OF ANKER ENERGY CORPORATION

INTRODUCTION

Thank you for the opportunity to present the views of Anker Energy Corporation regarding the Coal Industry Retiree Health Benefit Act ("the Act"). Anker Energy is a related person to a "reachback company". A reachback company is a company which was not signatory to a contract with the UMMA in 1992, but was signatory to a UMMA contract at some time since 1950 and employed at least two UMMA miners for at least one day. Under the Act, such companies are assigned liability to the "Combined Fund" created by the Act not only for the health benefits of miners they employed, but also for a percentage of the benefit costs of miners whose employers are no longer in business.

Anker Energy never signed a union contract. But the Act contains a "related person" clause, which provides that if a former employer is insolvent or no longer in business, companies related to the former employer (such as its parent or its sibling corporations) will be liable for the former employer's retiree health benefit costs. The reachback provision, together with the related person provision, burdens operators like Anker Energy with onerous and unfair liability for the health benefits of persons with little or no connection to the operator. Reachback operators are forced to pay benefits that they never contracted to provide.

The fundamental goal of the Act is to ensure that these miners receive adequate retiree health benefits. Anker Energy wishes to contribute to this goal, and is willing to pay its fair share of the costs of these benefits. However, Anker Energy believes that the disproportionate and unfair impact of the Act in its present state, not only overburdens coal companies that had limited union involvement, but negatively impacts the livelihood of its workers.

Anker Energy is a West Virginia coal company that provides coal to customers in 14 states. In its 20 years of business, Anker Energy affiliates had only two limited periods of employment under the UMWA coal wage agreements. The first occurred in the late 1970s when an Anker Energy affiliate, acquired and unsuccessfully tried to revitalize a mine owned by an insolvent unionized operator. This involvement lasted only 6 months. The second occurred in the early 1980s when another Anker Energy affiliate acquired a coal mine from one of the largest members of the Bituminous Coal Operators Association ("BCOA"), and operated it for only 4 years.

In both cases, Anker Energy affiliates employed the miners for only a fraction of their mining careers; they worked the bulk of their careers for someone else. But in both cases, the Act forces Anker Energy to pay full lifetime retiree health benefits to these miners and their dependents, as well as a portion of the retiree health benefit costs of unassigned miners and beneficiaries, resulting in a disproportionate and unfair burden on Anker.

Anker Energy competes with large BCOA companies that are receiving a substantial cost savings as a result of the Act. Even the BCOA has estimated annual savings to its members in excess of \$100 million. As a result, Anker Energy is placed at a competitive disadvantage. The competitive disadvantage is especially severe because Anker Energy sells coal in the spot market where BCOA companies traditionally sell coal at lower prices. This competitive disadvantage has serious implications for Anker Energy and the over 600 West Virginians it employs. While the Act raises Anker Energy's per-ton cost of producing coal, it lowers the per-ton cost of Anker Energy's BCOA competitors — clearly not the original intent of the Act.

Anker Energy supports proposals for alleviating the Act's burdens for all coal operators, such as H.R. 1370, but it believes that bill would better serve its purpose if it rectified the disproportionate effects of the Act. Full relief would exempt from the Act coal producers whose union activities have been limited. As it stands, the bill reduces premiums based in proportion to an operator's assigned beneficiaries as a percentage of all assigned beneficiaries. Even though this helps reachback operators compete with companies that rely

heavily on union employment, it makes no special provisions for the reachback operators who have suffered the most under the Act. The unfair competitive advantage that the Act gave to the larger operators when the Act was passed will not be removed.

A Company should not be assessed liability as a "related person" when the miners were employed by the company less than one year.

In the late 1970's, an affiliate of Anker Energy purchased the stock of Reliable Coal Company, a small, insolvent UMWA-organized coal company. Anker Energy intended to turn the company around by retooling Reliable's facilities to mine metallurgical coal -- a highly competitive business where coal prices are established in the world market. Anker Energy borrowed large sums of money and invested it in the mine, intending to sell metallurgical coal at a price high enough to service the debt. However, Anker Energy's cost of borrowing skyrocketed when interest rates climbed above 20 percent, and its expected revenues plummeted when the price of metallurgical coal dropped, making it impossible to continue the operation without losing the entire company. Market conditions forced Anker Energy to close the mine after only 6 months. It is worth emphasizing that the Reliable miners were laid off because of unavoidable market forces, not because of union affiliation.

Under the Act, Anker Energy is considered a related party to Reliable, the last employer of these miners to have signed a coal wage agreement. Therefore, even though Anker Energy's controlled group employed Reliable's miners for only 6 months, the Act holds Anker Energy solely liable for the lifetime retiree health benefits of 50 former miners of Reliable and every member of their families, as well as a portion of the lifetime retiree health benefit costs of unassigned beneficiaries. The 50 Reliable miners worked in the mines for more than 20 years. The Anker affiliate employed them for only 6 months. Yet Anker must foot the bill for all of their lifetime retiree health benefits, and that of their families. In other words, they worked for an Anker affiliate for less than 1/40th of their work life, but Anker must pay 1004 of their benefits and the benefits of their families. Clearly, this imposes an unfair burden on Anker.

The Act should be amended to protect companies that have employed miners for short periods of time from being held liable for lifetime health benefits earned through years of employment with other coal operators.

Contract miners should not be liable under the reachback provision for the health benefits of retirees who were employed in a contract mining arrangement.

Coal mining operations often involve a bifurcation of rights, with one company owning the economic rights to the coal reserves (the "contracting company") and another company (the "contract miner") performing the mining under contract for the benefit of the contracting company. In certain circumstances, the reachback provision of the Act has the effect of unfairly allocating liability for retiree health benefits to contract miners rather than to the contracting company.

One of Anker Energy's affiliates, King Knob Coal Company ("King Knob"), operated as a contract miner for one of the largest coal companies in the United States. The contracting company is a BCOA company and a member of the BCOA team that negotiates the coal wage agreements. As a condition of its contract mining relationship with this large contracting company, King Knob was required to sign a coal wage agreement and use only union workers to mine the coal. Under the mining agreement, the contracting company, not King Knob, was required to pay the health benefit contributions for the miners employed by King Knob on the contracting company's behalf. This arrangement

continued for 15 years, at which time the contracting company unilaterally terminated its contract with King Knob, causing the layoff of most of the miners. King Knob later acquired the reserves from the contracting company, hired back some of the laid off miners, and over the next 4 years mined out the remaining reserves and closed down the mine.

Under the reachback provision of the Act, however, even though the contracting company (i) effectively employed these miners for 15 out of the 19 years coal was extracted from this mine, (ii) was contractually obligated to pay all miner health benefits during the 15 years, and (iii) caused the layoff of these miners when it unilaterally terminated the contract, the Combined Fund has assigned it none of the liability for the retiree health benefits. Instead, the Combined Fund has required King Knob to pay all the retiree health benefits of the miners employed by the operation, the health benefits of their dependents, and a portion of the retiree health benefit costs of unassigned beneficiaries.

To rectify this inequity, the reachback provision of the Act should be modified in the context of a contracting company/contract miner relationship so that upon termination of a mining contract by a contracting company, the retiree health benefits of miners who were laid off as a result of the contract termination are attributable to the contracting company rather than the contract miner.

CONCLUSION

In closing, we ask this subcommittee to review the Act and the inequity it has created in its attempt to protect miner's benefits. We support efforts to reform the Act, such as H.R. 1370, which would rebate surplus assets to all entities paying into the Combined Fund. But to be truly fair, reform should provide for a more equitable allocation of retiree health benefit liability than that provided by the Act. These changes could mean the difference between survival and insolvency for many coal companies.

Mr. PORTMAN. Thank you. John B. Patton, president of Davon Inc., Columbus, Ohio is recognized.

STATEMENT OF JOHN B. PATTON, PRESIDENT, DAVON INC., COLUMBUS, OHIO

Mr. PATTON. Distinguished Members of the Committee, thank you for asking me to testify. I am John Patton. I am the owner and president of Davon Inc., an Ohio business. We manufacture and deliver ready-mixed concrete products and mine and process limestone, sand and gravel. We employ 275 people, with excellent wages and benefits in the high unemployment areas of south central Ohio. Many of our employees are represented by the International Union of Operating Engineers. The union has actively supported us in seeking relief from the 1992 coal act.

There are three groups of companies affected by this legislation and the differences between them are significant. The first group is the post-1988 companies, those in the coal business after 1988,

including the current members of the BCOA.

The second group is the reach-back companies, those in the coal business from 1978 through 1988. The third group is the super reach-back companies, those who left the coal business before 1978. Davon is a super reach-back company.

Please review the summary chronology attached to my written testimony, which shows there is absolutely no connection between super reach-back companies, including Davon, and the alleged problems that Congress sought to address in the 1992 coal act.

Davon's predecessor, the New York Coal Co., sold all of its coal mining interest in 1954. I would like to repeat, in 1954. We have in no way been affiliated with the coal business since then. Davon was formed in the late fifties after my family purchased the stock of the New York Coal Co., then a Maine corporation. They renamed the company and reincorporated it into Ohio. So, Davon has never been in the coal business.

Let's focus on 1978, a crucial year as it relates to Davon and the 1992 coal act. In 1978, the year the UMWA retirees were promised lifetime benefits at the bargaining table by all companies then in the coal business; 1978, the year singled out to delineate the super reach-back companies from the reach-back companies; 1978, the Coal Commission report which led to this act recommended only applying the act to the post-1978 companies. The commission would not have included Davon and other super reach-backs; 1978, Davon and Templeton, who you will hear from in the next panel, had been out of the coal business for 24 years.

The act does not even generate significant revenues from super reach-backs. They represent only about \$10.8 million or no more than 3 percent of anticipated fund revenues, which is insignificant to the fund's revenue from other sources or its surplus, which is well over \$100 million.

Super reach-backs should be excluded before battle lines are drawn over the amount of the surplus and what, if any, other changes should be made to the act.

They should be exempt because it is wrong to include them in the first place, not because there may now be a surplus. A super reach-back exemption should not be contingent upon any specific

level of surplus.

Miners were promised benefits and they should get them, but those who promised the benefits should pay for them. If it were not for this law, the BCOA and others would have to pay these health insurance premiums, as they promised to do in collective bargaining.

This brings us to the true effect of this law. The act, without any conceivable justification, takes our money and uses it to pay for an

obligation of the BCOA and others.

The 1992 coal act has cost Davon over \$800,000. It has drained capital from our company and cost us jobs. The proposed Myers-Hancock bill does not give super reach-backs the complete exemption they deserve. It treats us like other reach-back companies. We are not like them. We were long gone in the coal industry when retiree health benefits were promised in 1978.

A mistake has been made. Remember 1978. Honor it as a legitimate cutoff date and please exempt all super reach-backs from this legislation. We do not belong in it.

[The prepared statement follows]:

TESTIMONY OF JOHN B. PATTON PRESIDENT OF DAVON INC. OF COLUMBUS, OHIO BEFORE THE SUBCOMMITTEE ON OVERSIGHT, COMMITTEE ON WAYS AND MEANS, UNITED STATES HOUSE OF REPRESENTATIVES Washington, D.C., June 22, 1995

Good morning Madam Chairman and members of the subcommittee. Thank you for inviting me to testify.

I am the owner and president of Davon, an Ohio business. We manufacture and deliver ready-mix concrete products and mine and process limestone, sand and gravel. We employ 275 people, with excellent wages and benefits, in the high unemployment areas of south central Ohio. Many of our employees are represented by the International Union of Operating Engineers. The union has actively supported us in seeking relief from the 1992 Coal Act.

There are three groups of companies affected by this legislation and the differences between them are significant:

- Post-1988 companies: those in the coal business after 1988, including the current members of the BCOA;
- 2) "Reachback" companies: those in the coal business from 1978 through 1988; and
- "SUPER" Reachback" companies: those who left the coal business before 1978; Davon is a SUPER Reachback company.

Please review the summary chronology attached to my written testimony which shows there is absolutely no connection between SUPER Reachback companies, including Davon, and the alleged problems that Congress sought to address in the 1992 Coal Act.

Davon's predecessor, New York Coal Company, sold all of its coal mining interest in 1954. We have in no way been affiliated with the coal business since then. Davon was formed in the late 1950's after my family purchased stock of the New York Coal Company, then Maine corporation. They re-named the company and re-incorporated in into Ohio. So,

DAVON HAS NEVER BEEN IN THE COAL BUSINESS.

Let's focus on 1978, a crucial year as it relates to Davon and the 1992 Coal Act.

- 1978: the year UMWA retirees were promised lifetime benefits at the bargaining table by all companies then in the coal business.
- 1978: the year singled out to delineate the SUPER Reachback companies from Reachback companies.
- 1978: The Coal Commission report, which lead to this Act, recommended only applying the Act to the post-1978 companies; the Commission would not have included Davon Inc. and other SUPER Reachbacks.
- 1978: Davon (and Templeton) had been out of the coal business for 24 years.

The Act does not even generate significant revenue from SUPER Reachbacks. They represent only about \$10.8 million, or no more than 3% of anticipated fund revenues, which is insignificant to the Fund's revenue from other sources, or its surplus which is well over \$100 million.

SUPER Reachbacks should be excluded BEFORE battle lines are drawn over the amount of the surplus and what, if any, other changes should be made to the Act. They should be exempt because it was wrong to include them in the first place, not because there may now be a surplus. A SUPER Reachback exemption should not be contingent on any specific level of surplus.

Miners were promised benefits and should get them. But those who promised the benefits should pay for them, not SUPER Reachback companies. If it were not for this law, the BCOA and others would have to pay these health insurance premiums, as they promised to do in collective bargaining. This brings us to the true effect of this law. The Act, without any conceivable justification, takes our money and uses it to pay for an obligation of the BCOA and others. The 1992 Coal Act has cost Davon over \$800,000. It has drained capital from our company and cost jobs.

The proposed Myers Hancock Bill does not give SUPER Reachbacks the complete exemption they deserve. It treats us like other Reachback companies. We are not like them! We were long gone from the Coal Industry when retiree health benefits were promised in 1978.

A mistake has been made. Remember 1978. Honor it as the legitimate cut off date and please exempt all SUPER Reachbacks from this legislation. We do not belong in it!

Mr. PORTMAN. Thank you. Alan T. Law is recognized.

STATEMENT OF ALAN T. LAW, PRESIDENT, MOUNTAIN LAUREL RESOURCES COMPANY, MOUNT HOPE, WEST VIRGINIA

Mr. LAW. I am Alan Law, president of the Mountain Laurel Resources Co. Thank you, Mr. Chairman and Members of the Subcommittee for this opportunity to address you on an issue which is of utmost concern for me and my company.

I am here to represent not only my company, but also all of those small reach-back companies whose corporate lives and in some cases personal livelihood have been destroyed by the coal act. Through a stock purchase, I acquired Mountain Laurel in 1992 before the enactment of the coal act.

In 1989, Mountain Laurel negotiated an agreement with trustees of the health and retirement funds for a full and complete settlement of our obligations to the funds at that time.

I would like to quote from a letter dated July 25, 1989, whereby Mountain Laurel sent a letter to the fund expressing our condition on accepting the agreement.

The UMWA health and retirements funds hereby release and discharge forever Mountain Laurel Resources Co. and its predecessor, the New River company, and all persons acting by, through or for said companies from any and all claims, complaints, liabilities, obligations, courses of action and demands of any kind whatsoever, either currently pending against said companies or unasserted, known or unknown to the United Mine Workers of America health and retirement funds for and in consideration of the withdrawal of liabilities here and before set forth to be paid by Mountain Laurel Resources Co.

Based on that agreement and what we thought was a valid and binding agreement, we proceeded to restructure our company. With only six employees, we were primarily interested in the property holdings for the recreational development potential and not in further development of its coal holdings.

I had absolutely no interest in running a coal mining company and I have never employed a coal miner. For nearly a decade the coal activity of our company has been limited to the receipt of passive income from coal leases. I first became aware of the magnitude of our potential disaster in mid-1993 and my worst fears were confirmed in October of that year when we received premium properties for a total of 2,071 miners and dependents.

The annual premiums assessed were in excess of \$5.1 million, or five times the company's current annual revenues. Obviously, this amount was beyond our financial capability, and all the more frightening was the IRS penalty of more than \$200,000 per day if we failed to pay. I appealed to the new combined fund and to then Treasury Secretary Lloyd Bentsen for their urgent help, all to no avail.

In testimony before your Committee in September 1993, I heard then-Assistant Secretary Leslie Samuels advise the members that while the administration could not support a bankruptcy exemption for companies which could not pay the premiums due, he was confident that companies could respond to their premium notices by asking the combined fund trustees for a stretched out payment schedule, and that this would be discretionary with the trustees.

I am here before you today to testify that based on my experience, no such stretched out payment schedule is possible. Based on the conduct of the combined fund in my case, it appears that the trustees possess no such discretion whatsoever to enter into long-term pay out agreements.

With our first \$420,000 monthly premium due on November 25, 1993, and with no response from the fund to our plea for help or assistance, we were forced to file for bankruptcy on November 19, 1993. Unfortunately, our nightmare did not end with the filing of

our petition for reorganization.

Our initial assignment of beneficiaries was so inaccurate, many of our premiums were required to pay for benefits for the dead. Our assigned beneficiaries included my wife's uncle, who died 16 years ago, and literally dozens of beneficiaries who are allegedly more than 100 years old. Other assigned beneficiaries only worked for the company for a matter of weeks, but that did not matter. They said if you once employed a miner under the UMWA agreement and are technically still in business and the miner has retired, you could be liable for a lifetime of benefits.

So, Mountain Laurel was put into bankruptcy. Eighty-eight years' worth of work proudly serving West Virginia and our Nation's industrial sector down the drain. It is not enough to be put in bankruptcy, however. Lawyers for the combined fund continue to hound me and my wife over every single company expenditure, including the company-provided health insurance policies for

us.

Every time we travel to Washington to plead for relief from this nightmare, every expense is challenged by their examiners. In their latest move, the trustees have threatened to sue me and my wife personally under some ultra ego theory for the total net present value of the liability, which is now to be estimated to be \$40 million. Indeed, they have given me a copy of their proposed complaint to prove that they are serious.

In the past months since going into bankruptcy, I have attended several meetings with Senator Rockefeller and even more meetings with his staff. I believe that they are honestly dismayed and concerned at the impact the coal act has had on companies like mine. However, no corrective legislation has yet been proposed that has

been acceptable by all parties.

Mr. Chairman, I applaud you. I know no one wants to revisit this enormously complex and contentious issue, but this problem needs fixing. If any form of relief is justified, is reasonable, is reasonable and is fair, it is relief for small reach-back companies who do not have the financial resources to meet their obligation imposed by the act. It is not that we just do not want to pay; we cannot.

Small companies need relief and we need it now. We cannot wait. With your help in the coming months, we can prevent more

Mountain Laurel bankruptcies this year. Thank you.

[The prepared statement follows:]

CONGRESSIONAL STATEMENT OF ALAN T. LAW

I am Alan Law, President of the Mountain Laurel Resources Company, Mt. Hope, West Virginia. Thank you, Madam Chairman and members of the subcommittee, for this opportunity to address you on an issue which is of the utmost concern for me and my company.

I am here to represent not only my company but also all of those small reachback companies whose corporate lives and in some cases personal livelihood have been destroyed by The Coal Act.

Through a stock purchase, I acquired Mountain Laurel¹ in 1992 before the enactment of The Coal Act. I have never employed a miner. With only six employees, we were primarily interested in the property holdings for their recreational development potential and not in the further development of its coal holdings. I had absolutely no interest in running a coal mining company. For nearly a decade, the coal activity of our company has been limited to the receipt of passive income from coal leases.

I first became aware of the magnitude of our potential disaster in mid 1993 and my worst fears were confirmed in October when we received premium notices for a total of 2,071 miners and dependents. The annual premiums assessed were in excess of \$5.1 million or five times the company's current annual revenues. Obviously, this amount was beyond our financial capability -- and all the more frightening was the IRS penalty of more than \$200,000 per day if we failed to pay. I appealed to the new Combined Fund and to then Treasury Secretary, Lloyd Bentsen, for their urgent help -- all to no avail.

In testimony before your full committee in October of 1993, I heard Assistant Secretary Leslie Samuels advise the members that while the Administration could not support a bankrupicy exemption for companies which could not pay the premiums due, he was confident that companies could respond to their premium notices "by asking the Combined Fund trustees for a stretched-out payment schedule" and that this would be "discretionary with the trustees."

I am here before you today to testify that based on my experience no such stretched-out payment schedule is possible. Based on the conduct of the Combined Fund in my case, it appears that the trustees possess no such discretion whatsoever to enter into long-term payment agreements.

With our first \$420,000 monthly premium due on November 25, 1993, and with no response from the Fund to our plea for help, we were forced to file for bankruptcy_on November 19, 1993. Unfortunately, our nightmare did not end with the filing of our petition for reorganization.

Our initial assignment of beneficiaries was so inaccurate, many of our premiums were required to pay for benefits for the dead. Our assigned beneficiaries included my wife's uncle who died 16 years ago and literally dozens of beneficiaries who are allegedly more than 100 years old. Other assigned beneficiaries only worked for the company for a matter of weeks. But that didn't matter. They said that if you once employed a miner under a UMW agreement and are technically "still in business," you could be held liable for a lifetime of benefits.

Mountain Laurel is the successor company to "The New River Company," historically one of the largest coal producing companies in West Virginia after its original founding in 1906. In the 1960's New River was acquired by CSX Railroad and subsequently sold off during its reorganization. Subsequently due to changing domestic and world metallurgical coal markets, Mountain Laurel ceased coal production in 1985 and was restructured into a coal reserve holding and service organization.

So Mountain Laurel was put into bankruptcy. Eighty-eight years worth of work, proudly serving West Virginia and our nation's industrial sector, down the drain.

It's not enough to be put in bankruptcy, however, lawyers for the Combined Fund continue to hound me and my wife over every single company expenditure including the company- provided health insurance policies for us -- every time we travel to Washington to "plead" for relief from this nightmare -- every expense is challenged, by their examiners. In their latest move, the trustees have threatened to sue me and my wife personally under some sort of "alter ego" theory for the total net present value of the liability which is now estimated to be \$40 million. Indeed they have given me a copy of their proposed complaint to prove that they are serious. They now have my wife's small, inactive landscaping firm, known as Mother Nature's Designs, in their gunsights -- when her firm only generated \$5,000 in earnings some five years ago.

In the past months since going into bankruptcy, I have also attended several meetings with Senator Rockefeller and even more meetings with his staff. I believe that they are honestly dismayed at the impact of The Coal Act has had on companies like mine, however, no corrective legislation has yet to be proposed to me.

Madam Chairman - I applaud you. I know no one wants to revisit this enormously complex and contentious issue, but this problem needs fixing. Small companies need relief and we need it now. We just can't wait. Only with your help in the coming months can we prevent more "Mountain Laurel" bankruptcies this year.

Thank you.

Mr. PORTMAN. Thank you, Mr. Law, and I thank all the panelists for excellent testimony. Some of my colleagues will be coming back in a moment.

The first question would apply to any of the companies represented. Given the liabilities you have talked about, what kind of litigation have you proceeded with—I would imagine that the litigation might stem from the 1992 Act. Maybe we can just go down the line, Mr. Miercort, starting with you. Have you filed any lawsuits subsequent to the 1992 Act?

Mr. Meircort. We have filed a constitutional challenge against the act. It has been consolidated with some other companies' challenges as well. It is being heard by the Washington district court. The oral argument will be next week. I think someone earlier did mention that the Federal District Court in Pittsburgh recently did declare that in the Unity Realty Case that the act is indeed unconstitutional.

Mr. PORTMAN. Do other companies have a different basis for litigation?

Mr. CHENOWETH. This is Rhys Best, chief executive officer of Lone Star Steel Co. I think he can answer that very directly.

Mr. BEST. He has worked so long on the problem. He has already retired from the company, so he is not familiar with our litigation. We filed a constitutional challenge in Texas in Federal Court and that is in discovery and preparation of papers. We are just filing responses to the requests from the various lawyers. It has not been set for hearing.

Mr. PORTMAN. And that also is on a constitutional basis?

Mr. BEST. Yes, it is. It is based as a constitutional challenge on Federal law on one case and the other challenge is that Lone Star filed for bankruptcy reorganization in June 1989 and was reorganized in May 1991, and so we do have a bankruptcy challenge, as well, under the Code.

Mr. FALTIS. We haven't filed any suit or started any action yet. We are asking for relief, though, at least on an administrative basis because we do not feel we rightfully have the liabilities that are being imposed on us.

Mr. PORTMAN. Mr. Patton?

Mr. PATTON. We have filed, again, a constitutionality issue. We have lost at the lower level. We are appealing. We made a very conscious decision when we began the litigation process to position this to go all the way to the Supreme Court if we could possibly get there, and that remains our intention today. We have also sought administrative relief from the SSA.

Mr. Portman. Mr. Patton, you mentioned in your testimony that your company has expended over \$800,000 already in relation to the super reach-back status that you have in relation to the problems before the Subsempittee today.

lems before the Subcommittee today.

Does that \$800,000 include your legal fees that you have expended?

Mr. PATTON. Yes, sir, it does.

Mr. PORTMAN. Could you give us an estimate of what your legal fees have been to date?

Mr. PATTON. Approximately \$330,000 to \$350,000.

Mr. Law. Our company is in the reorganization process in the bankruptcy court. I might tell you that under the combined fund's basic interpretation of this act, is that they consider these premiums or contributions to be a tax, and they consider them to be a necessary and actual expense of the estate that should be paid

as an administrative expense.

Certainly I do not hold this position and we will be filing challenges to that assertion in the near future. But if it is considered to be an administrative expense and a tax, then filing for bankruptcy protects no one. It becomes a nondischargeable item and they dictate the terms of their settlement with you or perhaps destroy your company completely and try to press for liquidation. So, we are actively involved in litigation with them.

Just last week we were served with some potential litigation where they want to lift the automatic status afforded by the bankruptcy court to proceed against my wife and I personally. So, it is

an ongoing battle with us.

Mr. PORTMAN. Thank you. I would like to relinquish the gavel and recognize the Chair of the Committee, Nancy Johnson, for questions.

Chairman JOHNSON [presiding]. Have any of you challenged

assignments made by the SSA of orphaned individuals?

Mr. MEIRCORT. Yes, Madam Chairman. We have challenged a number of the assignments. We had been assigned approximately 1,300 beneficiaries in total and we have challenged approximately 25 to 30 percent of them, on the order of 250. We have yet to hear one word from the administrative review. We have been told that ours is probably the last in the pile.

Chairman JOHNSON. How long ago did you challenge?

Mr. MIERCORT. This was several years ago; within the timeframes required by the act.

Chairman Johnson. And are you paying for that 30 percent at

Mr. MEIRCORT. Yes, ma'am, we are.

Chairman JOHNSON. If they reallocate them, will you be reim-

Mr. Meircort. It is my understanding that we will be if they are inappropriately allocated.

Chairman JOHNSON. And what does it cost you to challenge?

Mr. MIERCORT. The administrative cost of the challenge is probably in the tens of thousands of dollars for staff time and other work.

Chairman JOHNSON, Millions?

Mr. MEIRCORT. Thousands. In terms of the challenge, that itself is just staff time. In terms of our answer to Mr. Portman's earlier question, we have spent on the order of half a million dollars on

our legal challenge.

If possible, I would like to add one other comment regarding the legal challenge. I think it goes to a point that was made by one of the other members of this panel. The president of Davon made the point that there were lifetime benefits promised to all UMWA retirees in the 1978 agreement. That is factually incorrect. It is not true. It is clear by the documents that were entered into by the BCOA companies in 1978 that there was never a lifetime guarantee of benefits. That is one of the points in our oral arguments we will be making next week on the constitutionality challenge.

I can point you to the point in the documents, but will just read a couple of quotes from the agreements that we entered into, the

only ones that we signed.

The explicit agreement by the signatory employers to make specific contributions to the trust are effective during the life of this agreement. Another part of the agreement, ending when the agreement is terminated. Also, in the general description which some people cite as the area that says we promised lifetime employment, it says, health benefits are guaranteed during the term of this agreement subject to the terms of the agreement at the levels of benefits provided in the plans. There has never been ever a lifetime guarantee of payments.

[Additional written Subcommittee questions and the responses

submitted to North American Coal Corp. follow:

QUESTIONS FOR CLIFFORD R. MIERCORT OF THE REACHBACK COMPANY PANEL

1. Have you appealed any assignments of employees made by the Social Security Administration? With what result? At what expense?

Yes, 231 beneficiaries to date. After 13 months, we received review of only 46. Of this 46, 35 were removed from our billing list. There are currently 185 challenges outstanding. To date, these challenges have cost us approximately \$200,000.

2. Do you have any pending litigation under the 1992 Act?

Yes, a constitutional challenge.

3. Can you describe what your legal costs have been?

Approximately \$200,000.

4. What is your approximate annual premium liability under the Act?

\$3 million

5. What steps would you recommend that Congress take to remedy the problems created by the 1992 Act?

H.R.1370 would provide some temporary relief; however, I recommend consideration be given to providing permanent relief to reachback companies.

Chairman JOHNSON. Thank you. We have to leave to vote in 5 minutes and when we leave to vote I am going to recess the hearing for half an hour.

I want to ask the panel if you could very quickly compare the benefits you are providing under this program to the benefits you

are providing to your own employees?

Mr. FALTIS. If I may, we have extensive benefit plans for our employees and cover almost 100 percent of everything. We have an incentive program that we share cost savings with our employees, but the actual benefit that we guarantee our employees is very broad and we have adopted in our own operations, our employees aren't represented by a union, but we also provide for retiree health costs as well.

Chairman JOHNSON. Do you provide for grandparents and grandchildren? In your definition of family benefits, do you include

grandparents and grandchildren?

Mr. FALTIS. No. What we do is we have a defined contribution plan, so we provide a pool of money to our employees both through a 401(h) and a 401(k) so that they will have a pool of money to draw upon. It is different for retirees. It is not a defined benefit plan, but a pool of money that they can draw upon for their benefits.

Chairman JOHNSON. For their medical benefits?

Mr. FALTIS. Medical, yes. We have both a 401(h) and a 401(k). Chairman JOHNSON. Any others?

Mr. BEST. I am Rhys Best, chief executive officer of Lone Star Steel Co. We employ 1,500 employees approximately, 1,000 represented by the United Steelworkers of America. So, we have union employees.

Our health care plan extends to the employee and their immediate dependents through age 22 and that is all. We also by contract do not provide any health care benefits beyond age 65. That is a contract that we have had for over 30 years.

The actual benefits within the plan are very adequate, but are much less than what I have read in the BCOA agreements.

Mr. MIERCORT. For North American Coal we provide benefits for the employee and direct dependents until age 21 and we have an 80/20 copay situation so the level of benefits is much more modest.

Mr. PATTON. We have a comprehensive health care program, again, 80/20, benefits for dependents up to age 21. We presently have no health care benefits for retirees.

Chairman JOHNSON. So, you are contributing under this plan to a considerably richer benefit plan that defines dependent benefits far more broadly in terms of who is provided benefits as well as what benefits are provided than you are for your own employees; is that a fair statement?

Mr. Patton. That is correct.

Chairman JOHNSON. I assume, Mr. Law, that before you ended up in bankruptcy that you had a similar situation.

Mr. Law. Currently we have an 80/20 copay with \$1,000 deductible, but it is just two employees, myself and a receptionist/secretary.

Chairman JOHNSON. There are many fairness issues here and you have helped to shed some light on some of them and we thank you for being here and for your testimony.

[Recess.]

Chairman JOHNSON. The hearing will reconvene.

Members are tied up with a vote still, but they will be returning promptly and we have a series of amendments that are going to be considered and then the votes bunched, so that will result in another significant recess. I want to get started and move as quickly as possible.

Mr. Kindig, the president of Pittston Coal Co., will begin.

Welcome.

STATEMENT OF KARL K. KINDIG, PRESIDENT, PITTSTON COAL CO., STAMFORD, CONNECTICUT

Mr. KINDIG. Thank you.

I am Karl Kindig, president and chief executive officer of Pittston Coal Co. from Lebanon, VA. Pittston is a subsidiary of the Pittston Co. located in Stamford, CT.

I would summarize my testimony and ask that my full testimony

be included in the record.

The Pittston Co., and specifically Pittston Coal Co., support retiree medical benefits. As a company, we provide medical benefits for thousands of our retirees, not all of them as generous as those that have been mandated by the coal act, but we do provide those benefits for our retirees and strongly support the concept of retiree benefits, particularly those negotiated in a collective bargaining

arrangement.

I would like to make three points. Some of them have been made before today. First of all, that the coal act resulted in a very significant shift of the burden for retiree health care in the coal industry, from a group of companies that had agreed in a collective bargaining agreement to assume that burden to a large number of companies that had not agreed to assume that burden; that the crisis that led to the enactment of the coal act was largely manufactured; and that the coal act is a significant threat, in my view, to the concept that collective bargaining is the foundation for the Federal labor policy.

The shift of the burden by the coal act has been well documented. It is documented in the staff Committee report which I would note is a very thorough job, by and large. It is an excellent

report.

Clearly in their and in other testimony before this Committee, is documented the significant financial benefit that was received by the large BCOA companies at the expense of the reach-back compa-

nies and others.

I would also like to submit for the Committee's consideration a report by energy ventures analysis, a very reputable analytical firm in the coal industry, that details in some length the benefits received by the large BCOA companies and the burden shift that has been occasioned by this legislation.

The crisis that—the apparent crisis that led to the enactment of the coal act was largely manufactured by a series of events. The first event was the 1988 BCOA-UMWA agreement which shifted the mechanism for funding retiree medical benefits for the 1950 fund retirees from dollars per ton to cents per hour.

The rates set in that agreement were set at a level far below that necessary to fund those benefits and that fact was known by BCOA and UMWA at the time that that contract went into effect. They dealt with the problem in that contract by including a guarantee clause that provided that the signatory companies would make up any deficit caused by any underfunding.

The problem, of course, occurred—when the time came to honor that commitment, the BCOA companies simply did not pay. They refused to honor their guarantee clause and, therefore, caused a minor underfunding in the benefit fund which was used by the BCOA and the UMWA as a public relations ploy to create the appearance of a crisis that led to the enactment of the coal act. I think the statement that was read into the record by Congressman Hancock at the early part of this hearing is very good evidence of that.

From a collective bargaining standpoint, Pittston engaged in a lengthy collective bargaining process with United Mine Workers in 1989 and 1990, that ultimately culminated in a collective bargaining agreement. That process was with the direct participation of the Federal Government.

The collective bargaining process was under the auspices of then-Secretary Dole and former Secretary of Labor William Usury as mediator through much of that process. The Federal Government was very much involved in the collective bargaining agreement, people were aware of what was in the collective bargaining agreement, and as part of that collective bargaining agreement, we made provision for millions of dollars of contribution to the 1950 fund, as well as continuing to provide our single employer benefit plan under the 1974 fund.

The coal act, despite that Federal involvement essentially abrogated our collective bargaining agreement. I think that Congress ought to ask the question whether it is going to set itself up as the arbiter of last resort for parties to collective bargaining agreements who want to improve their position after the collective bargaining process is over. If that is to be the policy of the Federal Government, I think it has grave consequences for what heretofore has been the foundation of Federal labor law, that is the encouragement of collective bargaining between private parties.

That concludes my remarks.

[The prepared statement follows:]

Testimony of Karl K, Kindig Before the Ways and Means Subcommittee on Oversight to Examine the Operation of the Energy Act of 1992 Related to the Funding and Providing of Health Benefits of Retired Coal Miners June 22, 1995

Good morning Madam Chairman and Members of the Subcommittee. My name is Karl Kindig and I am President and Chief Executive Officer of the Pittston Coal Company (Pittston), a subsidiary of The Pittston Company of Stamford, Connecticut. I am here today to voice support for the Committee's thorough review of the impact of the Coal Act.

In doing so, I want to emphasize that over the years we have been, and continue to be, committed to supporting health benefits for retired mine workers. Amending the flawed Coal Act will not in any way harm the beneficiaries of the Combined Fund. We appreciate the opportunity to appear before you Madam Chairman and distinguished members of the Oversight Committee, to explain the devastating effects of this punitive tax and why it is necessary to amend the Act.

The Coal Act

The Coal Industry Retiree Health Benefit Act of 1992 established the Combined Fund as of February 1, 1993 by merging two existing UMWA retiree health benefit trusts. The Combined Fund is financed mostly by annual premiums assessed to certain companies, called operators, that signed any coal wage agreement with the UMWA after 1950, irrespective of whether those companies (i) were signatory to the 1988 National Bituminous Coal Wage Agreement between the BCOA and UMWA, (ii) had entered into a separate agreement with the UMWA for retiree health care or (iii) had exited the coal business. For companies, like Pittston, which had negotiated and fulfilled all of its commitments in a separate labor agreement, and for those companies which had complied with all contractual obligations prior to leaving the coal business, the Act constituted a punitive, retroactive employer mandate.

The Reachback Tax was promoted as an emergency effort to avoid a projected "deficit" in the United Mine Workers of America (UMWA) Retiree Health Benefit Funds. This deficit, however, never materialized. Instead, the UMWA Combined Benefit Fund Trustees estimate a more than \$145 million surplus growing at \$6.5 million per month. Meanwhile, the number of beneficiaries with claims against the Fund -- currently at less than 95,000 -- will continue to decline because of mortality. The underlying principle of the Reachback Tax was to protect against a shortfall that never occurred. This Ill-conceived tax was tacked on to the 1992 energy bill and was never critically reviewed. Had it been scrutinized, the damage done so far could have been avoided.

Shifting the Burden

The UMWA and the BCOA garnered support for the Coal Act by predictions of an imminent financial crisis in the health benefits plan, but the deficit which first appeared in the aggregate UMWA benefit funds in 1989 was entirely foreseen by the BCOA and the UMWA when they signed the 1988 wage agreement. This agreement changed the BCOA contribution formula from one based largely upon tonnage produced by a signatory company to one based exclusively upon the aggregate annual number of hours worked by its miners and set the hourly rate at a level known at the time to be inadequate. In addition to disadvantaging metallurgical coal producers like Pittston (which due to mining conditions produce fewer tons per man hour than steam coal producers), this change virtually guaranteed a static or declining level of BCOA contributions to the benefit funds in the face of rising health costs. While BCOA coal production remained constant, industry productivity increased and miners' man-hours plummeted. The less well capitalized producers and those who were engaged in more labor-intensive mining of metallurgical coal had imposed on them a greater proportion of the benefits obligation.

With the enactment of the Coal Act, the 1988 signatories further reduced their retiree medical expense by some \$135 million or 57%!

The manipulation of the funds for the benefit of the large BCOA companies is pervasive and well documented:

- 1988 Agreement BCOA and UMWA recognize that the new hours-based contribution formula was insufficient and would lead to under-funding. The BCOA maintained, and the UMWA agreed, that the Guarantee Clause, obligating the BCOA signatories to make up any shortfall, would adequately protect the Funds.
- 1990 1992 BCOA compenies renege on the Guarantee Clause obligations knowing that they would eventually have to pay but manufacturing the appearance of a crisis. The UMWA makes no effort to couple compliance with this contractual commitment.
- 1991 1992 UMWA cynically outlines a strategy to exploit the manufactured crisis in order to achieve Congressional action.
- 1992 Coal Act passed.
- 1993 Retirees' medical fund deficit "magically" disappears without any contribution from BCOA companies as contemplated by the Coal Act.

Abrogation

Pittston was uniquely impacted by the Coal Act since the statutory reachback provision abrogated Pittston's existing collective bargaining agreement with the United Mine Workers (UMWA). This agreement was negotiated after a long and bitter strike which resulted in civil penalties of over \$64 million being imposed upon the UMWA for violations of court-ordered injunctions. Following the intervention of former Labor Secretary Elizabeth Dole, and as a result of the direct mediation of former Labor Secretary William Usery, a complex settlement agreement was reached wherein Pittston agreed to contribute millions of dollars to the UMWA benefit funds and to continue providing medical benefits to post-1974 retirees under its single employer plan. The agreement also contained a unique provision requiring UMWA opposition to legislation such as the Coal Act. This provision was critical since Pittston feared, justifiably so in hindsight, that the UMWA and certain major producers would attempt to shift the burden of their benefit contributions to the backs of others and, in the process, upset our freely negotiated collective bargaining agreement. By its active support of the Coal Act, the UMWA breached this major provision. The Coal Act, in many ways, abrogated Pittston's collective bargaining agreement and undermined the Federal Government's commitment to collective bargaining as the comerstone of national labor policy.

Soft Export Markets

Pittston's competitors in the metallurgical marketplace are principally foreign companies or mining arms of socialized governments. Exporters of metallurgical coal, doing business in a highly competitive worldwide market, do not enjoy any form of long-term contract and cannot pass through the significant costs imposed by the Coal Act. Producers of steam coal for the domestic market, on the other hand, sell coal under long-term contracts which may allow such costs to be passed through to the consumer. Pittston, therefore, stands with a small number of similarly impacted companies having its ability to compete severely hampered. Today, because of the Coal Act, Pittston finds itself under severe financial pressure. Without Congressional action, Pittston will be hampered in its ability to raise the capital necessary to replace mines as their reserves are exhausted, thereby resulting in lost jobs in Appalachian communities which can ill afford additional economic hardship.

The major coal producers with multi-national interests, in a calculated move designed to freeze-out and eliminate competition, have become beneficiaries of the Coal Act at the expense of the Reachback companies like Pittston. Since 1988, the major coal companies which control the BCOA have used the retiree health care issue to improve their competitive position relative to their smaller competitors.

- Prior to 1988, retiree health care expense was assessed on the basis of dollars per ton of coal produced. Since coal is priced by the ton, no competitive advantage resulted.
- The 1988 shift from dollars-per-ton contributed to dollar-per-employee-hour produced a competitive advantage to the larger, highly-capitalized companies to the detriment of smaller, more labor-intensive companies.
- The Coal Act resulted in a further cost shift by substituting <u>past</u> employment rather than current economic activity which had been the historic measure of contribution. As a result of these manipulations, the BCOA companies as a whole have dramatically reduced their retiree medical liability, shifting the cost burden to those companies less able to pay.

Over time, the economic hardship visited by the Coal Act will result in further concentration in the coal industry as the smaller companies succumb to the economic burden of the Coal Act and either fail or are bought out by the BCOA companies.

Hancock-Myers Reachback Tax Relief Amendment, H.R. 1370

It is our goal and that of other Reachback companies to improve the Coal Act without causing harm to retired miners. The Hancock-Myers bill is one such effort. The growing surplus in the Fund would be used to reduce or eliminate the premiums assessed against the Reachback companies while maintaining a safety cushion of at least 10% of the previous year's costs. In the improbable event the Fund's expenses exceed the safety cushion, the Reachback Tax would be resumed.

Congress did not intend for the Fund to develop a surplus and did not provide for its occurrence. It is now Congress' responsibility to remedy a burdensome mandate in excess funding for the Combined Fund in order to reduce the surplus that is rapidly accumulating. The most recent report released by the internationally recognized benefit consulting firm, Towers Perrin, projects a January surplus of \$240.8 million by the year 2004. The Fund is a private fund created by Federal statute, which is financed by a small group of companies; as such, it is appropriate that Congress direct that any unintended surplus be distributed to the payor companies in a manner which is fair and equitable. The Hancock-Myers bill addresses the excess funding and remedies an unintended result by restoring surplus funds to those who have suffered the most under the Act's provision without, in any way, undermining the financial viability of the Retired Mine Workers Health Benefits Fund. It is important to emphasize that under the Hancock-Myers proposal the Reachback companies will continue to serve as guarantors of the Fund, fully liable for immediate payment of their premiums, should the Fund experience a shortfall.

Coal Act Benefits

Pittston is firmly committed to supporting those retirees, and their families, who worked for Pittston for a significant portion of their career, and who retired from Pittston, that is, Pittston's own retirees. While we are open to other legislative suggestions which correct the Coal Act's deficiencies, Pittston has not and will not support any action which assigns retired miners' health benefits costs without considering reasonable vesting standards and a company's ability to make payments. The Coal Act contains no such protections or provisions, assigning to Pittston and other Reachback companies responsibility for lifetime health care for former "employees" (and their families) who

worked for the company for as little as one shift, one day, one week, decades ago. Indeed, of the total beneficiaries, only 28% ever actually worked in the mines. We consider the transition from tonnage to man-hours to liability based on <u>past</u> employment to be a harsh lesson about power and special interest politics. The real winners under the Coal Act are not the retired miners, whose benefits were never at risk, but the large BCOA companies which, with the compilicity of the UMWA, have used this issue in the most cynical manner imaginable to further their own economic interests.

Closing

We are extremely pleased that the majority of the Ways and Means Committee has cosponsored legislation amending the Coal Act. We urge prompt enactment of corrective legislation to remedy the effects of the flawed Act. I would be happy to answer any questions from the Chairman and the distinguished members of this Subcommittee.

Chairman Johnson. Very useful remarks Mr. Kindig. Mr. Ives.

STATEMENT OF J. ATWOOD (WOODY) IVES, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, EASTERN ENTERPRISES, WESTON. MASSACHUSETTS

Mr. IVES. Thank you, Madam Chairman, and good afternoon.

I am chairman and chief executive officer of Eastern Enterprises. Eastern Enterprises owns a gas utility in New England and a marine transportation company operating on the inland waterways. So, why am I here?

In September 1993, out of the blue, we received a bill for over \$5 million under the coal act. I did not know what the coal act was. I did know that Eastern had previously been in the coal business, but it had not employed a single coal miner since 1965. Yet, under the act, we are being asked to pay for lifetime health and death benefits for more than 1,400 miners and dependents. Some of these miners had worked for Eastern for less than a week.

The projected aggregate cost of these benefits imposed on us is between \$70 and \$100 million. Now you know why I am here.

Eastern does not challenge the basic principle that miners and their dependents should receive all of the benefits contracted for on their behalf by their union, but what we do question and what is simply wrong, is the decision to reach back and impose millions of dollars of liability on companies that are no longer in the coal business, never made any of the promises that the act is intended to enforce, and never contributed in any way to the creation of the perceived funding crisis. Eastern should not have been included in the act because it never made the promises the act seeks to enforce.

Let me explain. First, prior to 1965, when Eastern was in the coal business, it met all of its contractual obligations to its miners. Eastern left the coal business 30 years ago when it created a separate corporation, Eastern Associated Coal, which took over all of the assets and liabilities of Eastern's coal operations, including responsibility for its miners' benefits.

Second, Eastern never signed a Coal Wage Agreement after 1964. The Coal Commission, appointed by Secretary Dole, found that only the 1978 and subsequent UMWA agreements had promised and guaranteed retiree health and death benefits for miners and their dependents. However, the act as finally passed inexplicably reached back to include former operators who never promised lifetime benefits or signed the guarantee or evergreen clauses in the 1978 agreements. Even the Senate sponsors of the act admit that they never intended to include those super reachback companies in the act.

Third, one of the problems the coal act sought to cure was that of coal companies dumping their miners into the fund when leaving the industry. Eastern never dumped a single miner. The successor company to Eastern's coal operations continued Eastern's former mining operations, employed its union miners and made all of the contributions to the fund that Eastern would have made had Eastern itself continued in the business.

If you want to talk about dumping, the BCOA is the real dumper. They reduced their annual contribution to the fund by \$350 million as a result of the 1988 UMWA agreement. Further, under the act, they dumped the financial responsibility for the promises

they made on super reach-backs and reach-backs alike.

The coal act hits us where it hurts. The imposition of this grossly unfair liability significantly impedes Eastern's ability to invest in its current operations and interferes with the legitimate expectations of Eastern's shareholders. The up to \$100 million liability imposed on Eastern by the act has dollar-for-dollar, reduced its ability to invest in its current operations located in New England, Florida, Minnesota, Missouri, Ohio, and Pennsylvania, among other States.

In sum, it is totally inappropriate to include super reach-back

companies such as Eastern in the coal act.

Fact, super reach-backs in the aggregate have less than a \$13 million annual assessment under the act. This is less than 4 percent of the \$350 million annual reduction BCOA members negotiated for themselves in the 1988 contract. Any principled modification to the act should address this gross inequity.

Thank you.

[The prepared statement follows:]

STATEMENT OF J. ATWOOD IVES, CHAIRMAN AND CEO EASTERN ENTERPRISES, WESTON, MA

BEFORE THE SUBCOMMITTEE ON OVERSIGHT COMMITTEE ON WAYS AND MEANS U.S. HOUSE OF REPRESENTATIVES

ON THE COAL INDUSTRY RETIREE HEALTH BENEFIT ACT OF 1992 JUNE 22, 1995

Madam Chairman and Members of the Subcommittee, I greatly appreciate the opportunity to appear before you today as you review the impact of the Coal Industry Retiree - Health Benefit Act of 1992 (the "Coal Act"). Because of the unfairness of this statute and its unjust effects on companies like Eastern Enterprises ("Eastern"), which I will describe, I urge you to enact legislation to provide relief from the Act to that group of companies most unfairly included within its reach.

Eastern stopped mining coal in 1965. After that time it never again employed a miner and never again signed a United Mineworkers of America ("UMWA") coal industry wage agreement. Nonetheless, the Coal Act imposes liability on Eastern for over \$70 million to fund the lifetime health and death benefits for retirees and their families that were promised by other coal operators in later UMWA agreements, years after Eastern left the industry.

Eastern does not challenge the basic principle that miners and their dependents should receive all of the benefits contracted for on their behalf by their union. We do question, however, whether Congress actually had to step in and take such extraordinary measures to insure that miners' benefits would be funded, and believe it was simply wrong for Congress to reach back and impose millions of dollars of liability on companies like Eastern that never made any of the promises that the Act is intended to enforce and that never contributed in any way to the creation of the perceived funding problem.

Let me give you a brief overview of Eastern and how it came to be involved with the Coal Act. The facts will show that the Coal Act's imposition of liability on super reachback companies such as Eastern is inequitable and should be rectified. H.R. 1370 is a beginning — a more principled response would be to exempt super reachbacks from the Act altogether.

Eastern Enterprises

Eastern is a holding company headquartered in Weston, Massachusetts, which owns two operating subsidiaries: Boston Gas Company, a gas utility, and Midland Enterprises, a marine transportation company headquartered in Ohio that operates barges on the inland waterways. Since Eastern owns no coal fields or coal leases and has been out of the coal business for thirty years, you can imagine how surprised we were when, on a Friday in September 1993, out of the blue, we received an initial bill for \$5 million for Coal Act liabilities. According to the bill, Eastern was assigned 1,427 coal miners and dependents for whose lifetime benefits Eastern and its subsidiaries would thenceforth be responsible. All of the miners worked for Eastern 30-50 years ago; some worked for a total of less than a week and earned a total of less than \$100 in wages. Nonetheless, the Coal Act requires Eastern to

pay lifetime health premiums for such individuals and their dependents. Eastern's total liability under the Coal Act is projected at \$70-100 million!

How did Eastern get saddled with this unbelievable liability without any knowledge of or involvement in the funding problem that gave rise to the Coal Act? That is a question we have been asking ourselves for almost two years.

The Coal Act of 1992

As this Subcommittee is well aware, the purpose of the Coal Act is to assure that UMWA retirees and dependents will receive for life the benefits promised in collective bargaining agreements negotiated by the UMWA and the Bituminous Coal Operators' Association ("BCOA"). The Act is based substantially on the 1990 findings of the Coal Commission, a body appointed by then Secretary of Labor Elizabeth Dole, to address the perceived funding crisis. As it turns out, the so-called funding crisis may actually have been created by the BCOA, which negotiated dramatic changes in the funding formula in 1988, significantly reducing the signatory coal operators' annual payments to the funds and inevitably leading to the problem. The initial bill approved by Congress would have replenished the funds through an industry-wide coal tax. That measure was vetoed by President Bush. Congress next considered legislation to reach back and lock in earlier commitments made by signatories to the 1978 and later national bituminous coal wage agreements ("NBCWAs") in accordance with the Coal Commission's conclusions that signatories to those later agreements had promised and guaranteed contributions for UMWA retiree health and death benefits to the funds and thus could be statutorily forced to contribute to their funding.

It is important to remember that the collective bargaining agreements prior to 1974 provided for defined contributions to the UMWA funds and made no promise of any particular level of benefits, or even that benefits would continue once available monies were spent. The 1974 agreement for the first time committed funds to provide lifetime benefits for miners and greatly expanded the class of covered individuals; the 1978 agreement for the first time committed employers to contribute enough to assure payment of the 1974-promised benefits into the future. Thus, those agreements brought about major transformations in the nature and funding of retiree health benefits, completely replacing and fundamentally restructuring the benefits promised to miners and retirees under previous agreements.

When Congress finally enacted the Coal Act, it included at the last minute — without hearings or full public airing — provisions that would "reach back" to hold liable for fund contributions any signatory to a union coal wage agreement not just going back to 1978, but going all the way back to 1950, notwithstanding the Coal Commission's recommendations. While firms that had signed the 1974 and 1978 agreements had at least arguably made promises to pay lifetime benefits indefinitely, the Act inexplicably also held liable those who had exited the coal industry before 1974.

Thus did Eastern, which had been out of the coal business since 1965, get pulled into the Coal Act.

Eastern's Former Coal Business

Eastern was in the coal business and was signatory to wage agreements with the UMWA only from 1950 through 1964. During that time, Eastern complied fully with each and every obligation it had under those agreements and contributed in excess of \$50 million in defined benefit contributions to the miners' benefit plans.

In 1965, Eastern transferred its coal operations to a new subsidiary, Eastern Associated Coal Corp. ("EACC"). EACC was the successor to Eastern's coal operations; it took over Eastern's assets and assumed Eastern's coal-related liabilities, including responsibility for all Black Lung benefit claims as well as for all other past and future obligations to miners. EACC continued virtually every aspect of the operations of Eastern's former coal division: it employed the same miners, utilized the same management, operated the same mines and machinery, maintained the same company housing and stores, operated the same summer camp for the children and grandchildren of miners, and assumed the banking relationships of its predecessor. Most important, EACC fulfilled Eastern's obligations under the existing 1964 – NBCWA, thereafter signed the subsequent NBCWAs, including the 1974 and 1978 agreements, and made all of the contributions to the UMWA funds that Eastern would have made had it stayed in the coal business. It thus only seems logical and appropriate that EACC, not Eastern, should be financially responsible for the promises it made.

Peabody Coal Company, owned by Hanson PLC, a British conglomerate with over thirty billion dollars in assets, now owns EACC and continues its operations and derives revenues therefrom to this day. Ironically, one effect of the Coal Act is to allow companies, like Peabody, that signed the 1974 and 1978 agreements, to reduce substantially their funding obligations for retiree health benefits while huge liabilities for those obligations are directed to companies like Eastern that are no longer in the coal business.

Eastern Never "Dumped" Miners

Both the Coal Commission and Congress identified as a key factor giving rise to the funding problem the exit from the coal business of bituminous coal operators in ways that left their mines unworked, or their employees without jobs or at work for nonunion companies that did not contribute to any UMWA funds. Unlike those operators, Eastern never abandoned its miners by terminating coal operations. Eastern never converted its operations to nonunion status. In short, Eastern never "dumped" a single union miner or retiree -- it never shifted the liability for the health care of its employees to other employers. Quite the contrary, Eastern's former coal operations have continued in operation under Peabody and have continued to generate revenues to support the UMWA funds. Eastern was not a contributor to the problem, but, under the Coal Act, it was forced, without notice, to be part of the solution.

Fairness and Equity

Many of the stories being related to the Subcommittee today tell of family firms and small companies being bankrupted by the Coal Act. Many of the stories involve hardship and distress. That is not Eastern's tale. We are, fortunately, a healthy company. However, the \$70-100 million in premiums that we have been assessed under the Coal Act represent almost a quarter of Eastern's total net worth (shareholder investment). This huge liability has a direct dampening effect on Eastern's existing operations by decreasing the amount of capital -- dollar for dollar -- available for investment in such non-coal operations. Eastern already has or will have to contemplate reduced investments in New England, Ohio, Minnesota, Missouri, and

Florida, among other states. This drain on capital ultimately reduces Eastern's ability to be competitive in the solely non-coal businesses in which it is engaged.

Investors, whether managers of giant retirement funds or individuals with their personal savings, should be able to rely on an understanding of a company's current operations when making investment decisions. The Coal Act manifestly interferes with the legitimate expectations of Eastern's shareholders and investors by imposing, long after the fact, a totally unexpected and unreasonable retroactive liability. Neither Eastern nor its investors could have anticipated this enormous liability in the absence of any rational connection between the liability and Eastern's former coal operations.

The people who have a stake in Eastern and its operating companies, whether investors, employees, retirees, or customers, should not have to bail out companies that remain in the coal business today. Those who sell coal and can properly allocate the cost of miners' health care benefits to those sales can and should pay for these benefits, particularly since they, and not Eastern, promised them.

Imposing liability on Eastern under the Coal Act is unfair and inconsistent with the purposes of the Act. The objective of the legislation was to affirm — and to provide a framework for — administering preexisting private contractual promises and agreements voluntarily made by signatories to the 1974 and subsequent UMWA agreements. Eastern and other super reachback companies never signed those agreements and never made those promises. They should be relieved from Coal Act liability.

Strong arguments have been advanced by reachback companies as to why they should not be liable under the Coal Act. While they did sign the 1978 UMWA agreement (and later agreements prior to 1988), their commitment was limited to contributions from current operations, and they completely fulfilled that obligation. Eastern supports relief for all reachback companies.

Legislative Proposals and Coal Miners

Neither H.R. 1370 nor even the entire elimination of Coal Act liability for Eastern and other super reachbacks would deprive a single UMWA retiree or dependent of his or her benefits. Not only does there currently exist an estimated \$145 million surplus in the Fund, but it is also our understanding that premiums from all super reachbacks amount to only \$10-13 million annually, and not all super reachbacks are able to pay.

In closing, let me summarize: Eastern is a super reachback company that never promised the benefits the Coal Act was meant to protect. Moreover, Eastern never shut down union mining operations or dumped miners or retirees for others to support. As a non-dumping, super reachback company, we in no way created or added to the funding problem, and any modification to the Coal Act should address our situation. Certainly, there is no principled basis for including super reachbacks in the Coal Act or otherwise requiring them to pay for promises made by other companies. At the very least, everyone ought to be able to agree that the Act needs to be amended to exempt this class of companies.

I appreciate having the opportunity to testify today and urge the Subcommittee to approve legislation to relieve from liability under the Coal Act those companies, like Eastern, that should have never been included in the first place.

Chairman JOHNSON. Thank you. Ms. Gerwin.

STATEMENT OF SUZANNE GERWIN, ON BEHALF OF THE BUCHANAN COUNTY COAL CO., CINCINNATI, OHIO

Ms. Gerwin. Good afternoon, Madam Chairman. I am Suzanne Gerwin, appearing on behalf of my mother, Viea Taylor, who due to extremely poor health is unable to appear before you today. She asks that I tell you all how much she appreciates your Subcommittee examining the impact of the coal act and to hearing testimony on the plight of the reach-back companies, apparently the only parties to suffer due to the enactment of the 1992 coal act.

My mother is the president of Buchanan County Coal Corp., and under the 1992 act, the company was assigned 57 beneficiaries, mostly surviving spouses. Buchanan has not mined any coal since 1974 and has not been party to UMWA wage agreement since 1966. And yet our first 12 months of premiums totaled nearly

\$200,000.

Thanks to the coal act, my mother was made responsible for the lifetime health care benefits for miners and their dependents who worked for my grandfather for a matter of months in the fifties and sixties. Currently, Buchanan County Coal receives only passive income through the receipt of income on one land lease, but that lease income is not nearly enough to pay for the premiums. To forestall bankruptcy and the imposition of huge IRS penalties, mother has been forced to liquidate personal assets to pay the reach-back bill.

Her total contributions as of May 25 have been \$274,887.86. I have spent a number of months trying to understand how we could be held responsible for these people. I have struggled through verbal smog and rhetoric of evergreen clauses, obligations, dump-

ing, orphan miners.

I have tried to understand the significance of the 1978 agreement and the reach-backs and what all this had to do with me. When it came to me, it was pretty simple. When my grandfather's coal company was in business, UMWA Health and Pension program was run by the union. The plan was supported by a multiemployer agreement to make a pay-as-you-go contribution based on current production. Buchanan and every other company paid asset contributions whether or not it had any retirees at all.

When the company left the coal business, it stopped paying and new entrants started to pay. This is how things always worked.

Basically, I feel that we have all been exploited. I think that BCOA has become a cartel and that they have exploited everyone from the retired mine worker, current mine worker, the Federal Government, and ultimately the American taxpayer. BCOA exploited the fear of retirees. They are afraid of losing their health care. They exploited the union fear of losing union jobs.

They exploited Congress by deceiving it into believing there was a crisis which justified it rewriting collective bargaining agreements, imposing this reach-back tax and handing over public dollars to support a private pension fund. This cynical exploitation of

us all by BCOA has forced the following tragic results:

Some companies are snuffed out immediately. The Lanzendorfer Trucking Co. in Pennsylvania cannot even afford to make the first premium payment. Other companies like the Codell and Ward Coal Co. in Lexington, Kentucky, would never be able to pay the first premium, and the surmounting penalties I think of about \$6 million will send Codell to its grave, I know.

There are other companies like Rick Wienzierl's company, Barnes and Tucker, in Pennsylvania, they will die a slow death. They have been paying nearly \$4 million a year into the fund and he has been forced to cannibalize his company to generate enough cash to pay the premiums each month. He has 12 employees and his company

probably will not survive the year.

I want to conclude by saying that I resent the position that my mother and I have put in. We are being portrayed as rich coal barons who want to do nothing but make money and we do not want to pay for our miners's health care. Neither my mother or grandfather ever operated Buchanan County Coal in a dubious fashion or dumped anyone. They paid what they owed.

I think that this whole shifting of costs and retiree health care is a shell game and I think the red ball is the miners' health care fund, and I think you all know who I think the shell game operator

is—it is basically the BCOA.

I hope that this hearing will provide the necessary momentum for the Congress to act this year in enacting relief for all reachback companies irrespective of size, particularly before all small reach-back companies disappear.

Thank you.

[The prepared statement follows:]

STATEMENT OF SUZANNE GERWIN on behalf of THE BUCHANAN COUNTY COAL CO

I am Suzanne Gerwin and I am appearing on behalf of my mother, Viea Taylor, who due to her extremely poor health was unable to appear before you today. She asked that I tell you how much she appreciates your subcommittee examining the impact of The Coal Act and to hearing testimony on the plight of the reachback companies -- apparently the only parties to suffer due to the enactment of the 1992 Coal Act.

My Mother is the president of Buchanan County Coal Corporation and under the 1992 Act, the company was assigned 57 beneficiaries - mostly surviving spouses. Buchanan has not mined any coal since 1974 and it has not been a party to a UMWA wage agreement since 1966. And yet our first twelve months of premiums totalled nearly \$200,000. Thanks to The Coal Act, my mother was made responsible for the lifetime health care benefits for miners and their dependents who worked for my grandfather for a matter of months in the 1950's and 1960's.

I have spent a number of months trying to understand exactly how we could be held responsible for these people. I struggled through the verbal smog of BCOA rhetoric about "evergreen clauses", moral obligations, and dumping of orphan miners. I tried to understand the significance of the 1978 agreement and the reachbacks and what all this had to do with me. Finally, when it came to me, it was pretty simple. When my grandfather's coal company was in business, the UMWA health and pension program was run by the union. The plan was supported by a multi-employer agreement to make pay-as-you-go contributions based on current production. Buchanan and every other company paid a set contribution whether or not it had any retirees at all. When a company left the coal business, it stopped paying and new entrants started to pay. This is how things always worked.

The game changed somewhat after 1978 when the employers set up their own individual benefit plans in order to stop the continuing waste in a plan run by the union.

However, the rules never changed for retirees pre-1976 -- they were still in the union plan supported by multi-employer pay-as-you-go contributions. The pre-1976 retirees are the vast majority of the current retirees (more than 80,000). They were in the so-called 1950 Fund.

The BCOA and the Rockefeller bill applies to those pre-1976 retirees the concept of individual company responsibility and the concept of "orphan miner" which never existed with respect to those retirees.

Under this verbal facade, the BCOA has constructed a bold and ingenious scheme to saddle the reachback companies and the entire coal industry through the AML fund with a huge share of costs of the 1950 Fund which belongs rightfully only to them.

This is truly shameful particularly when it is obvious that the BCOA could fully afford to pay what it actually owes.

Currently Buchanan County Coal receives only passive income through the receipt of income from one land lease but that lease income has not been nearly enough to pay the premiums. To forestall bankruptcy-and the imposition of huge IRS penalties, my mother has been forced to liquidate personal assets to pay the reachback bill. Her total contributions are now \$274.887.86.

Just last week in response to her appeal to SSA, she was notified by one of the Social Security field offices that the beneficiaries may have been improperly assigned. We still don't know if this decision is final but if it is, she won't be forced to liquidate her holdings in Premier Industries where my brother and I are employed. Premier makes paper plates, hot dog holders and ash trays -- it has never had any connection to the coal industry. Without relief from SSA, the Coal Act had put Premier Industries at

risk and the jobs of 54 people (primarily single mothers) in Covington, Ky. at risk. Premier provides health care coverage for these employees - many of whom have pre-existing conditions. How sad and how ironic if the Coal Act had resulted in the elimination not only of the employment of 54 workers but their health insurance coverage as well.

I hope the SSA decision will become final and that we may be among the lucky few to escape the reachback web. For those who have not been so lucky and who previously testified before you, I would like to update you on their woes:

- Rick Wienzierl of Barnes and Tucker in Pennsylvania has been paying nearly \$4 million annually to the Fund. He has been forced to cannibalize his company to generate enough cash to pay the premiums each month. His 12-employee company will probably not survive the year;
- 2) The Lanzendorfers' only ties to the coal industry were through the hauling of Union-mined Coal. This three employee trucking firm could never afford to pay any of their monthly premiums and they wait each day in fear that the trustees will enforce the obligation and force them into bankruptcy;
- The Coal Act forced M&H Coal, a small 1988 signatory, into bankruptcy resulting in the loss of more than one hundred and twenty jobs in West Virginia.
- CF&I Steel's bankruptcy judge discharged their Coal Act obligations and the company was subsequently acquired by an Oregon steel company.

This is but a small sample - the list goes on and on.

I hope Madam Chairman that this hearing will provide the necessary momentum for the Congress to act this year in enacting relief for all reachback companies irrespective of size — particularly before all of the small reachback companies disappear Thank you.

Chairman JOHNSON. Thank you for your testimony. Mr. Templeton.

STATEMENT OF THOMAS E. TEMPLETON, PRESIDENT, TEMPLETON COAL CO., TERRE HAUTE, INDIANA

Mr. TEMPLETON. Thank you, Madam Chairman. I am Tom Templeton, president of Templeton Coal Co. Inc., of Terre Haute, Indiana. I am here on behalf of my company, our subsidiary, Sherwood Templeton Coal Co. and Princeton Mining Co., and we support H.R. 1370. Although all three companies I speak for today have coal or mining in their names, all of us left the mining industry in the fifties and sixties and have never reentered the coal min-

ing business.

The coal act imposes a tax liability on the former reach-back coal companies who had signed UMWA agreements as far back as 1950. The whole premise of the coal act was that coal companies had made so-called promises to provide lifetime health care benefits for retired miners and their families in 1978 and later. Super reach-back companies are those that did not sign the 1978 or later agreements with the UMWA. The coal act sponsors said they wanted to stop companies from dumping their responsibility onto the companies that had faithfully kept their commitments. Instead, the coal act empowers major largely foreign-owned operating coal companies to abandon the contracts they negotiated and dump their obligation on companies like us who left the industry generations ago. This is a travesty and surely not what Congress truly intended to happen.

There are four major reasons why the reach-back tax should not apply to companies like Templeton, Princeton Mining and Sherwood Templeton. The alleged promises were in an agreement signed by BCOA companies in 1978 and later. The coal act imposed liability on Templeton for promises it could not have made since it left the collective bargaining process in 1954, 24 years before these

agreements were negotiated.

Second, Templeton has been given responsibility for about 36 beneficiaries, including an estimated 9 orphans. Only 4 of the 36 beneficiaries ever worked for Templeton and only 2 of those are still alive. Templeton's funding of the original plan should have been sufficient to carry those four miners through their retirement, though Templeton did not promise it would. But the new plan that BCOA and UMWA created in the seventies, added 23 Templeton miners' wives and dramatically increased benefit levels without Templeton's knowledge or consent. The funding formula of the old and new plan still withstood all these increases until the BCOA and UMWA changed the funding formulas in 1988.

Third, the coal act compels Templeton to pay for orphan beneficiaries. Some of these orphans retired from other companies as recently as 1992, 38 years following Templeton's exit from coal mining. We will be required to pay for orphan benefits until about

the year 2030 and probably longer.

This is 76 years after we left the coal business and 24 years after mortality tables suggest our last assigned beneficiary will die. These orphans were never associated with Templeton and likely do not even know we exist. Even though fund transfers have paid the

orphans so far, we expect transfers to end in about 2004, leaving us to pay the next 26 years.

Templeton expects to pay just over a million dollars for all the coal act premiums over the 30 to 40 years of liability. We estimate we could pay \$52,000, if only paying for our assigned miners.

Fourth, we do not believe even the coal act primary sponsors intended to involve companies signing UMWA contracts earlier than the alleged 1978 promises. In fact, the Dole Commission which Congress appointed in 1989 to study the problem and make recommendations, did not suggest going back further than 1978. The super reach-back provisions were added by the conference Committee and were never debated by the House or the Senate.

Let there be no confusion about our interest in the well-being of miners. Our company's founders, my grandfather, John A. Templeton, and my great-uncle Philip Penna left dismal lives as miners in their native Scotland and England to come to America in search of better working conditions.

Eventually, Templeton worked his way through the mining ranks to become a mine boss, and Penna was instrumental in the founding of the UMWA, becoming its second international president. Then in 1920, Templeton and Penna founded Templeton Coal Co.

Inc. Templeton mines were always union mines.

However, demand for our deep coal declined significantly in the fifties, and in 1954 we decided to close our last mine. Though the company was in financial crisis, it did what was right for its employees, as it always had done in the past. Templeton satisfied all its obligations to its miners and their benefits under the 1950 Welfare and Retirement Fund.

Templeton began diversifying in the fifties. Instead of mining coal, we now produce laboratory equipment, inspirational gifts, electric heating elements and plastic bathroom accessories and distribute plumbing, heating and air-conditioning products. We also lease land to others for farming and coal production.

We hope the Congress will completely exempt coal act liability for super reach-back companies like ours who left the industry before 1978. Super reach-backs have no accountability to the situation and represent no more than three percent of anticipated fund revenues.

In conclusion, I ask that you please consider our story carefully. Is it right that Congress impose a tax on our companies for a busi-

ness we left four decades ago?

Is it fair that we be held accountable for promises operating companies may have made over two decades after we left the coal mining business? How long should we be forced to fund retiree health care benefits for people who never worked for Templeton, and how can it be that a company is legally mandated to pay retiree benefits 24 years after its last retiree dies?

We have been paying our coal act premiums while spending countless hours and dollars resisting this dreadful circumstance. We could be using this time and these dollars developing new business as our competitors are doing. It is not right and only Congress can make it right.

Thank you for your time and consideration.

[The prepared statement follows:]

HOUSE OF REPRESENTATIVES COMMITTEE ON WAYS AND MEANS SUBCOMMITTEE ON OVERSIGHT

HEARING ON PROVISIONS OF THE ENERGY ACT OF 1992 RELATED TO THE FUNDING AND PROVIDING OF HEALTH BENEFITS OF RETIRED COAL MINERS

June 22, 1995

STATEMENT

Thomas E. Templeton
President
Templeton Coal Company, Inc.

Speaking On Behalf Of

TEMPLETON COAL COMPANY, INC.

Terre Haute, Indiana

SHERWOOD-TEMPLETON COAL COMPANY, INC.

Indianapolis, Indiana

PRINCETON MINING COMPANY, INC.

Terre Haute, Indiana

I. Introduction

My name is Tom Templeton, and I am president of Templeton Coal Company, Inc. of Terre Haute, Indiana. I am here on behalf of my company, our subsidiary Sherwood-Templeton Coal Company, Inc., and Princeton Mining Company. We support H.R. 1370. Although all three companies I speak for today have "coal" or "mining" in their names, please understand that all of us left the mining industry in the 1950's and 60's and have never re-entered the coal mining business.

Templeton's history is illustrative of the fundamental unfairness thrust upon it and similarly situated companies, such as Princeton Mining and Sherwood-Templeton, because of changes made to the health care benefits of retired coal miners decades after we left the coal mining business. The Coal Act imposes a tax liability on former "Reachback" coal companies who had signed a UMWA agreement as far back as 1950. The whole premise of the Coal Act was that coal companies had made so-called promises to provide "lifetime healthcare benefits" for retired miners and their families in 1978 and later.

"Super-Reachback" companies are those, like Templeton, that did not sign the 1978 or later agreements with UMWA. The Coal Act sponsors said they wanted to stop companies from dumping their responsibilities onto the companies that have faithfully kept their commitments. Instead, the Coal Act empowers major, largely foreign-owned, operating coal companies to abandon the contracts they negotiated and dump their obligations on companies like Templeton, Princeton, and Sherwood-Templeton who left the industry generations ago! This is a travesty, and surely not what Congress truly intended to happen.

II. Why The Reachback Tax Should Not Apply to Super-Reachbacks like Templeton, Sherwood-Templeton, and Princeton

There are four major reasons why the Reachback tax should not apply to companies like Templeton, Princeton, and Sherwood-Templeton:

- The first reason is obvious. The alleged "promises" were in agreements signed by BCOA
 companies in 1978 and later. The Coal Act imposed liability on Templeton for promises it
 could not have made, since it left the collective bargaining process in 1954, 24 years before
 these agreements were first negotiated.
- 2. Templeton has now been given responsibility for about 36 beneficiaries, including an estimated 9 orphans. Only 4 of the 36 beneficiaries ever worked as miners for Templeton and only 2 of those are still alive. Templeton's funding of the original plan should have been sufficient to carry those 4 miners through their retirement, though Templeton did not promise it would. The BCOA and UMWA created a new plan in 1974 after dissolving the plan Templeton had funded. The new plan added 23 Templeton miners' wives and dramatically increased benefit levels without Templeton's knowledge or consent. The funding formula of the old and new plans still withstood all of these increases until the BCOA and UMWA changed the funding formulas in 1988.
- 3. The Coal Act compels Templeton to pay for orphan beneficiaries. Some of these orphans retired from other companies as recently as 1992, 38 years following Templeton's exit from coal mining. We will be required to pay for orphan benefits until about the year 2030, probably longer. That is 76 years after we left the coal business and 24 years after mortality tables suggest our last assigned beneficiary will die. These orphans were never associated with Templeton and likely do not even know we exist. Though fund transfers have paid the orphan charges so far, we expect these transfers to end in about 2004, leaving us to pay the next 26 years. Templeton expects to pay just over \$1 million (including Sherwood-Templeton) for all Coal Act premiums over the 30 to 40 years of liability. Templeton expects it would only pay \$51,910 if paying only for its 4 assigned miners and not wives or orphans.
- 4. We do not believe even the Coal Act's primary sponsors originally intended to involve companies signing UMWA contracts earlier than the alleged 1978 promises. In fact, the Dole Commission, whom Congress appointed in 1989 to study the problem and make recommendations, did not suggest going back further than 1978. The Super-Reachback provisions were added by the Conference Committee and were never debated by either the House or Senate.

III. Background of Templeton, Sherwood-Templeton, and Princeton

A. Templeton Coal Company, Inc.

Let there be no confusion about Templeton's interest in the well-being of the miners. Our company's founders, my grandfather, John A. Templeton the first, and his brother-in-law, my great uncle Philip H. Penna, left dismal lives as miners in their native Scotland and England to come to America in search of better working conditions. Eventually, Templeton worked his way through the mining ranks to become a mine boss, and Penna was instrumental in the founding of the UMWA, becoming its second international president. Then in 1920 Templeton and Penna founded Templeton Coal Company, Inc. as president and vice president respectively. Templeton mines were always union mines. Mining was still dangerous, hard work, but Templeton, Penna, and the generations of Templeton family since then never forgot their past and treated miners with dignity, respect, and concern for their well being. The Company and its employees thrived in the 1920's, 30's, and 40's.

Templeton was signatory to National Bituminous Coal Wage Agreements (NBCWA) from 1950 until 1955, though it was never a member of the BCOA. Templeton last contributed \$.40 per ton of mined coal to that retirement and welfare fund. Templeton's contribution supported health care for retired miners as required by the NBCWA. Wives were not covered under the NBCWA. Wives were added by BCOA companies and the UMWA to the NBCWA in 1974. That year they abolished the plan Templeton had funded and created a new plan, to which Templeton was not a party.

Demand for our deep mined coal declined significantly in the 1950's, and in 1954 our board decided to close the last mine. Some miners worked into 1955 shutting down the mine. Though the company was in financial crisis, it did what was right for its employees, as they always had in the past. Templeton satisfied all its obligations to its miners, the miners' benefits under the 1950 Welfare and Retirement Fund, and its entire obligation to the UMWA. Templeton

contributed approximately \$850,527 into the Welfare and Retirement Fund between its beginning in 1950 until closure activities ended in 1955.

Templeton began diversifying in the 1950's. Instead of mining coal, we now produce laboratory equipment in Terre Haute Indiana, inspirational gifts in Seymour Indiana, electric heating elements in Allegan Michigan with some administrative services in Indianapolis, bathroom accessories in Franklin Indiana, and distribute plumbing, heating and air-conditioning products at 10 locations throughout Iowa. We also lease land for farming and coal production, mostly in Indiana and Illinois.

Under the broad definition of "related persons" in the 1992 Coal Act, all of these businesses suddenly bear liability for the cost of benefits for retired UMWA coal miners. Those costs are determined by the benefit levels and eligibility criteria as negotiated between the UMWA and the BCOA in 1988, 34 years after we closed our last mine. This sudden liability erodes the financial viability of these subsidiary companies.

Templeton was originally notified of 41 assigned beneficiaries. Through appeals with SSA the 41 has been reduced to 27, with a prospective liability of 9 orphans, or 36 beneficiaries altogether. Of the 27, 10 have already died. The Coal Act includes the dead when prorating orphan liability. Those 10 dead assigned beneficiaries and those who die later will create orphan liabilities for Templeton from the time orphan payments are expected to begin in 2004 until the fund ends around the year 2030. Only 4 of Templeton's 36 beneficiaries are retired miners that once received a health benefit while working for Templeton, and only 2 of those are still living. Templeton expects to pay \$924,000 for its 30-40 years of liability under the Coal Act, just over \$1 million when including Sherwood-Templeton. It would pay only \$51,910 if paying only for the miners it once covered.

B. Sherwood-Templeton Coal Company, Inc.

Sherwood-Templeton was signatory to National Bituminous Coal Wage Agreements from 1950 until 1960, though it was never a member of the BCOA. Sherwood-Templeton's contribution supported health care for retired miners as required by the NBCWA. Again, wives were not covered under the NBCWA. Wives were added to the NBCWA in 1974 under an entirely new plan.

In 1960 Sherwood-Templeton sold its last mine to AMAX. Sherwood-Templeton satisfied all its obligations to its miners, the miners' benefits under the 1950 Welfare and Retirement Fund, and its entire obligation to the UMWA. Sherwood-Templeton contributed approximately \$2,043,626 into the Welfare and Retirement Fund between its beginning in 1950 and the mine sale in 1960.

Sherwood-Templeton began diversifying in the 1970's. Instead of mining coal, it now produces electric heating elements in Allegan Michigan. It also leases land for farming and coal production, mostly in Indiana and Illinois.

Under the broad definition of "related persons" in the 1992 Coal Act, its Michigan business suddenly bears liability for the cost of benefits for retired UMWA coal miners. Those costs are determined by the benefit levels and eligibility criteria as negotiated between the UMWA and the BCOA in 1988, 28 years after selling its last mine and 18 years before the Michigan businesss was acquired. This sudden liability erodes the financial viability of this Michigan company.

Sherwood-Templeton was originally notified of 5 assigned beneficiaries. Through appeals with SSA that number has been reduced to 3, with a prospectiive liability of 1 orphan, for a total of 4 beneficiaries. One of the 3 dead. The Coal Act includes the dead when prorating orphan liability. The dead assigned beneficiary and those who die later will create orphan liabilities for Sherwood-Templeton from the time orphan payments are expected to begin in 2004 until around the year 2030. None of Sherwood-Templeton's assigned beneficiaries are retired miners that once received a health benefit while working for Sherwood-Templeton. Sherwood-Templeton expects to pay \$78,200 for its 30-40 years of liability under the Coal Act for people it

never, ever, provided a health benefit in the past. It would pay nothing if paying only for the miners it once covered.

C. Princeton Mining Company, Inc.

Princeton Mining Company was signatory to National Bituminous Coal Wage Agreements from 1950 until 1966, though it was never a member of the BCOA. Princeton Mining Company's contribution supported health care for retired miners as required by the NBCWA. Again, wives were not covered under the NBCWA. Wives were added to the NBCWA in 1974 under an entirely new plan.

In 1966 Princeton Mining Company leased its last mine to an unrelated corporation. Princeton Mining Company satisfied all its obligations to its miners, the miners' benefits under the 1950 Welfare and Retirement Fund, and its entire obligation to the UMWA. Princeton Mining Company contributed approximately \$3,300,000 into the Welfare and Retirement Fund between its beginning in 1950 and 1966.

Instead of mining coal, Princeton now produces agricultural commodities, processes and distributes popcorn wholesale, and owns certain oil well working interests, certain non-producing coal rights, and real estate

Princeton Mining Company has been assigned 127 beneficiaries, with 16 now dead. Princeton has a prospective liability of about 42 orphans, for a total of 169 beneficiaries. The Coal Act includes the dead when prorating orphan liability. Those 16 dead assigned beneficiaries and those who die later will create orphan liabilities for Princeton Mining Company from the time orphan payments are expected to begin in 2004 until the fund ends around the year 2030. Only 13 of 127 of Princeton Mining Company's assigned beneficiaries are retired miners that once received a health benefit while working for the Company. Princeton Mining Company expects to pay \$260,781 in 1995, though it would pay only \$30,542 if paying only for the miners it once covered. Princeton expects to pay several million dollars for its 30-40 years of liability under the Coal Act.

IV. Conclusion

We hope Congress will completely exempt Coal Act liability for Super-Reachback companies like ours who left the industry before 1978. Super-Reachbacks have no more accountability to the situation than car dealers and cattle ranchers and represent no more than 3% of anticipated fund revenues.

Please, consider our story carefully. Templeton's history was founded on the principles of respect of our union employees and doing what is right. Is it right that Congress imposed a tax on our companies for a business we left four decades ago? Is it fair that we be held accountable for promises operating coal companies may have made over two decades after we left the coal mining business? How long should we be forced to fund retiree health care benefits for people who never worked for us? How can it be that a company is legally mandated to pay retiree benefits over 24 years after its last retiree dies?

We have been paying our Coal Act premiums while spending countless hours and dollars resisting this dreadful circumstance. We could be using this time and these dollars developing new jobs and new business as our competitors are doing. It is just not right! Only Congress can make it right! Thank you for your time and consideration.

Chairman JOHNSON. Thank you.

I thank the panel.

Mr. Templeton in your testimony, you make a statement that was not one of the ones that you included in your oral testimony. You say that Templeton will spend just over \$1 million on these benefits, when if it had to pay only for the miners it once covered, it would only have to pay about \$52,000?

Mr. TEMPLETON. That is right.

Chairman JOHNSON. In other words, if you paid for the health benefits of the people that you employed even though you are no longer in the business, but if you reached back just to your own employees, it would cost \$52,000, are you talking about per year?

Mr. TEMPLETON. No, that would be over their remaining lives

rather than \$1 million.

Chairman JOHNSON. The reality is you will pay \$1 million?

Mr. TEMPLETON. Yes.

Chairman JOHNSON. That is very helpful, and the detail that you

included in your statement was very helpful.

Suzanne Gerwin, I wanted to clarify your conversations with the SSA. You say in your testimony that, just last week, in response to her appeal to SSA, your mother was notified by one of the field offices that the beneficiaries may have been improperly assigned.

What do they mean by, may have improperly assigned, and what impact will, may have, have on the payments that you are required

to make?

Ms. GERWIN. It is—we were notified by the Southeast Regional Office that we may have been erroneously assigned. We appealed our assignment on the basis of passive income, that Buchanan County Coal is no longer in business, and it is not. It has no activity. The impact may have been relieved is just that, it is I do not know what they mean and I won't know until I get the final letter from the Baltimore office. I am assuming that is where the head of the SSA is.

Chairman JOHNSON. At this point, you have some hope that your

appeal has succeeded?

Ms. Gerwin. Very much hope. I believe that every indication is that—we are not sending in our June 25 payment, and I know of only two other companies that have gotten relief in this fashion, and they ultimately do get their money back. That however—the impact that this 18-month or 16-month ordeal has had on my employer and my business—I make paper plates. That is what I do in Coving to the coverage of the cover

in Covington, Kentucky.

My brother and I run a paper plate manufacturing company. As soon as my mother's money was going to run out, probably around August, we were going to have to start paying the, I believe it is ten thousand-nine hundred something dollars a month premiums to the fund. We weren't going to let my mother go through bankruptcy. We would have stepped in and used basically moneys from Premier Industries, the paper plate manufacturing company to pay this fund, this tax. That impact would have been a drastic impact on my company and Premier.

We have 54 employees. We insure them. We find it ironic that we have 57 beneficiaries and the 54 jobs at Premier were in jeop-

ardy. They were going to lose their health care and their jobs, so

I jokingly said I will pay for the difference.

Chairman JOHNSON. From what you have heard today, are the benefits that you provide your employees more generous or less generous?

Ms. GERWIN. They are far less generous. We just do single coverage. We do not have the ability to pay full family coverage and do not at this point have a retiree benefit plan for our workers.

Chairman JOHNSON. Thank you.

Mr. Ives, in your statement on the third page, you mention that Eastern never converted its operations—Eastern never dumped a single miner or retiree. It never shifted the liability for the health care of its employees to other employers. Quite the contrary. Eastern's former coal operations have continued in operation under Peabody and have continued to generate revenues to support the UMWA fund. If your successor company is continuing to pay, aren't

you double reimbursing for those same people?

Mr. IVES. Technically, I think the answer is no to that. What I said in the testimony was that Eastern when it owned Eastern Associated Coal, paid all of the contributions that Eastern Associated Coal as a subsidiary of Eastern should pay, and when it left the business, the funds were sound and in good financial shape. The coal act reaches back to employees who were employees of Eastern when it operated its coal businesses in 1965 and prior. This was back when the UMWA agreements and the BCOA agreements—

Chairman JOHNSON. Is there an overlap between the employee group of 65 prior, and the employee group of 65 post?

Mr. IVES. Not that I am aware of.

Chairman JOHNSON. So, the successor company generated a whole new work force?

Mr. IVES. No. The people who worked for Eastern Associated Coal now work for Eastern Associated Coal owned by Peabody.

Chairman JOHNSON. I understand that there would be some people that were not employed by the new company that had been employed by you but had left for one reason or another.

Mr. IVES. Prior to 1966.

Chairman JOHNSON. Are you paying only for those? Has there been an adjustment so that you are not paying for the people who went to the successor company and who are being paid for through the successor company?

Mr. IVES. We have only been billed for those who worked for

Eastern prior to 1966.

Chairman JOHNSON. And who did not continue in the employ of the successor company?

Mr. IVES. That is my belief.

Chairman JOHNSON. Thank you. I wanted to clarify that.

Mr. Kendig, you mention on the second page of your testimony that this agreement changed the BCOA contribution formula from one based largely on tonnage produced by a signatory company, to one based exclusively on the aggregate number of hours worked by its miners. That shift from tonnage to hours worked seems to be the cause of the change in liability burden amongst the companies, the shifting of that burden from basically high-production, low-

worker companies to the less-efficient, higher labor cost companies.

What would happen if we shifted that back?

Mr. KINDIG. I think that certainly—we sell coal by the ton, not by the hour and we certainly believe that a tonnage based payment is more equitable because it distributes the costs across the economic units that we actually sell. When the BCOA determined to move from a tonnage rate to an hourly rate, that created a discrimination among all the coal companies subject to that agreement in respect to their productivity.

Those that have very large highly productive surface mines or long wall mines would have a benefit, and those that operated thin seams for different qualities of coal—in our case, we mine a substantial amount of metallurgical coal from very thin seems, some in the 42-inch range, and you do not get a lot of tons per man-hour. When you shift from a tonnage burden to an hourly burden, those companies that are less productive because of their mining conditions or because of their capitalization bear a greater burden than those that are highly efficient.

Chairman JOHNSON. Thank you.

Mr. Hancock.

Mr. HANCOCK. Mr. Templeton, when did you first hear about the coal act?

Mr. TEMPLETON. I think the first notice I got was an article in Forbes Magazine. I was aware of things going on in the industry, but never anything like this. Then because of that we began to look into it and one of our people went to a seminar about the coal act, and it was at that time, later in 1993, that we really learned the magnitude of what had hit us. Because of that, I wrote the National Coal Association, which one of our subsidiaries is a member of, and asked why didn't you inform the members of something like this?

In their return, they decided to remain neutral and mute on the issue. I wish they would have come out in favor of it. At least we would have known what was going on. So, it was only at that later time we found out what had happened.

Mr. HANCOCK. Do you know of any reach-back companies that

did have input in the drafting?

Mr. TEMPLETON. There were no hearings, as I understand it, so there was no input. The only thing I received later from the National Coal Association was that the Dole Commission Report indicated that there was consideration ongoing back as far as 1978 in assessing liability, but never anything going back to 1950.

Mr. HANCOCK. That is kind of an expo facto deal.

Mr. TEMPLETON. It certainly was—is.

Mr. HANCOCK. Ms. Gerwin, the situation that you are in—exactly how is Premier Industries connected to Buchanan Coal? Buchanan Coal is a corporation?

Ms. GERWIN. Yes, sir.

Mr. Hancock. A privately held corporation?

How many stockholders are involved—you have no stockholders

other than your mother?

Ms. GERWIN. No, sir. My grandfather died in 1976 and he left Buchanan County Coal to his two daughters. My mother gave my aunt a lump sum of money and my mother retained the land-lease income. I believe there is a tipple or some form of structure on the land down in Virginia somewhere, and she receives an income based on an easement situation.

Mr. HANCOCK. Are we talking about a mineral right lease of some kind?

Ms. GERWIN. Maybe. I do not really know. They call it like a—it is a very long lease, like 99 years. It is kind of like China or Hong Kong. They just pay us—we have never really, you know, wanted to rile them up and ask them why they keep sending us this money, because the company that pays us has not mined coal since I think the late seventies, and we continue to receive a lump sum ever spring from this company. That is basically what Buchanan is.

And Premier Industries, my father bought it in 1981 and he passed away in 1983. We make paper plates in Covington, Kentucky. Now, obviously, when my father died, he was president, the stock went to my mother, but she doesn't own Premier Industries. My brother and I own it.

Mr. HANCOCK. You and your brother own the stock of Premier Industries?

Ms. GERWIN. Yes, sir. It is nonvoting stock because she did not want her children to be able to have their way with the company. It is not voting stock. She basically has control of the purse-strings of Premier and we just run the company.

Am I clear?

Mr. HANCOCK. OK.

Ms. GERWIN. Basically this law, because what is going to happen is that there is no way my mother can afford to pay these premiums. She was—what am I going to do? Good luck mom—so then the obligation was going to fall onto Premier Industries.

Mr. HANCOCK. I understand that. Where I am having a bit of a problem, Buchanan Coal, it doesn't have any assets; is that correct?

Ms. GERWIN. It has an income once a year, one lump sum. We receive I think it is \$100 and something, \$100 and change, not much, and we receive it once a year. She has two—there are some bookkeepers that were on a pension, a retirement account in that company that she has to pay out of that.

Mr. HANCOCK. And she has paid in \$274,000 of personal assets? Ms. GERWIN. Yes, sir, and capital gains tax when she liquidated some stocks, P&G, Coca-Cola, so she had to sell stock and pay capital gains and then pay this. I was screaming at her, she was crazy to do that and she was terrified about the penalties.

Mr. HANCOCK. It seems she should just transfer the stock and let them sell it and she wouldn't have to pay capital gains on it. That wouldn't work except through some charity.

Has anybody on this panel heard of any type of a situation like this that has occurred before that the U.S. Congress has done?

Mr. IVES. No, sir. As a person not in the coal business and not finding out about the act until we got the bill, I said how can our country do this to us, interfere between two contractual parties who have the capacity to settle their differences and to pay the price? I saw the miners out there with their signs, keep the promises. We agree. Those who make them, should keep them.

Mr. HANCOCK. This Committee wants to make sure that, as I have mentioned two or three times, that the members of the UMWA get exactly what they were promised. It is a case of who

is legally obligated to pay for it.

One other question. We are in a situation now with Superfund. We have spent I do not know how many billions of dollars and most has gone for legal fees. Not much has been accomplished. Do you have any idea of what kind of legal fees have been involved in this thing since it started? I am sure that you all have been—

Ms. GERWIN. I know just to generate—

Mr. HANCOCK. Say legal and accounting fees.

Ms. GERWIN. To generate the appeal and to keep coming to Washington and lobby to find out, I know our Cincinnati law firm, we are in excess of \$60,000 and that is just last count. The bills keep coming in. I would estimate that we are approaching \$75,000 that we have spent so far. And that is to appeal. That is to basi-

cally get where we never should have, which is not here.

Mr. KINDIG. I have no idea what our legal fees are but I am sure that they would be shocking. They generally are anyway. I know that we have spent well over \$100,000 just to have a firm go through and check the assignments that were made to us of the various beneficiaries, found several people who were dead. They are still dead, but we are still paying for them, and that process seems to drag on.

We cannot seem to get the relevant parties despite the fact that we have submitted evidence that these people are dead to stop paying for them, so we keep sending them a check every month. I guess it will get adjusted sooner or later, but the cost of dealing with this act over and above the premium expense has been very significant.

Mr. TEMPLETON. We have spent in excess of \$250,000 in legal

expense in contesting the legislation.

Mr. IVES. Eastern Enterprises has spent in excess of \$1 million. We have challenged over 800 individual assignments. Each booklet that we have sent to the SSA is about an inch thick. The lady who testified today, Ms. O'Connell, says she has 34 cartons of filings that we have made with her. It takes that much time when the people that you are talking about worked for a company that you no longer own, that have been gone for 25 years.

The act is insidious in that it covers anybody who is an affiliate, so you have to look at not only who employed the people, but what is the affiliate company, which can be three or four transactions away from who the person on the Social Security card was in order to determine who the appropriate person is. The SSA has a difficult job. We also have challenged the constitutionality of the act in the

Federal Court of Massachusetts, which is pending.

Mr. HANCOCK. Madam Chairman, we have four companies represented here. We just mentioned 1.36 million dollars' worth of legal fees, and that probably does not count all the in-house time just to these four companies and not a penny of that went to help the miner; did it?

Mr. KINDIG. I did not want to know this number. Counsel informs me that the legal fees are in excess of \$2 million, in addition to the other costs.

Mr. HANCOCK. You just added another \$1.7 million, four companies, and not a penny of it to the benefit of the miners that we are concerned about.

Thank you, Madam Chairman.

Chairman JOHNSON. Mr. Portman.

Mr. PORTMAN. I thank the Chairman.

I have read all the testimony and I appreciate your being here

and the very excellent statements by all companies.

Ms. Gerwin, looking at your testimony and hearing some of the questions and answers, I want to commend you for taking the time to analyze this situation, and then in your testimony to put it in plain English. You have done a remarkable job of cutting through some of the bureaucratic language and some of the distracting arguments here and there, and have distilled it pretty well, especially as to the super reach-back companies. I think it is a huge fairness issue.

When you look at the super reach-back companies and what percentage they are paying into the fund, it is de minimus. The saddest part is it wasn't even necessary, and yet you have incurred all these fees.

I hope we can get to the point where we can go beyond the good legislation that Mr. Hancock has introduced and deal with the

super reach-back problem.

You have also spent a lot of time, looking at your testimony, in talking to others. You have testimony about the Lanzendorfers and H&H Coal, and CF&I, and Barnes & Tucker, so you have probably spent time talking to small businesses that are in your situation.

With that information, is there anything else you would like to add for the record about what these other companies are going through who are in a super reach-back position and struggling to

make ends meet?

Ms. GERWIN. I think the Committee needs to know there are a lot of companies out there. I have talked to about 40 in Kentucky alone, 10 or 15 in West Virginia, 2 or 3 in Ohio, a couple in Pennsylvania. The response is they are suspicious; this doesn't affect me. I said, that is what I said. They are like, I am not going to pay it. That is what I said.

My advice to them or what I was trying to get them to realize is that it is a law and that some day these penalties will have to be collected, and that being an ostrich and sticking your head in the sand may be an immediate solution, but it is not going to go away. This was before I knew we were going to have the chance to testify and bring this slight oversight to your attention.

They are scared. They are running, changing phone numbers. If I can call you on the phone and find you, I surely think the IRS

will be able to.

Lyda Codell, I talked to her. She is 78 years old. I tried to get her to come to Washington with me to talk to Senator Ford and Senator McConnell last year, she is too sick to come. Her grand-daughter said that she would come but she did not like to leave her grandmother. This woman's premiums are \$22,000 a month and she has not paid.

I calculated her penalty at around \$4 million and that was 11 months ago. So, I do not know what she is going to do if she ever

gets a notice in the mail from IRS. She will probably have a heart

attack or something.

To answer your question, there are a lot of companies out there and they are not able to appeal like I did. There are a lot of companies that have nowhere to turn. The law the way it is written applies to them. They employed miners; therefore, they are responsible.

Mr. Portman. Let me ask a couple of other questions. Mr. Ives, you talked about super reach-back and reach-back and why you think there is a difference. Obviously, the 1978 date is critical to that. Can you expand as to why you think super reach-back and

reach-back companies should be treated differently?

Mr. IVES. Yes, sir. I think both have been disadvantaged. I think that in 1974 and in 1978, when the promises of extended benefits were included in the contract, prior to 1974—most of the super reach-backs are prior to 1974—the benefit plans were defined contribution plans, which meant that the payments that were made by coal operators prior to that time paid the money to the UMWA Welfare and Retirement Fund of 1950, the union had their own funds, and they provided the benefits and were responsible for them, and there was zero promise of anything further than making those payments. And if the union ran out of money or misappropriated, or whatever else, that was their issue, not the company's issue. So, we feel that the companies who never had an implied promise and were paying into defined contribution plans had completed all their obligations.

I think that the reach-back companies were companies that had entered into agreements. I think they got torpedoed by the 1988 agreement where the funding got changed and they have a legitimate argument as well. I think our predicament is totally—is the

most egregious thing I have ever heard.

Mr. PORTMAN. Because you had not made a commitment?

Mr. IVES. No commitment at all.

Mr. PORTMAN. Thank you all for being here.

I hope we will be able to learn enough in today's proceedings to come up with a remedy for the most egregious example, I think, which is the super reach-back situation.

I vield back.

Chairman JOHNSON. Are your employee benefit plans as generous in benefits offered and in definition of family coverage as this plan?

I asked Ms. Gerwin that.

Mr. KINDIG. I am not aware of any plan other than the plans that are associated with the United Mine Workers that are anywhere near this generous. We think we provide adequate retiree medical care for our employees, but they are nowhere near this generous. If all our plans were this generous, we would be doing nothing but funding the plans, not investing in new job opportunities or anything else.

Mr. TEMPLETON. The same thing applies. We pay for employees, we share dependent coverage cost, but we have no plans that cover

health benefits for retirees.

Chairman JOHNSON. Thank you.

Mr. Ives.

Mr. IVES. We have health care benefit plans. We, like most other companies, have put in various capitation and copay as well as preferred provider programs that have actually lowered and significantly reduced the rate of increase in costs. Several of our plans have actually gone down in costs.

As a matter of fact, both regular employees and union employees at both Boston Gas and at Ohio River Co. are wondering why their benefits are being reduced at the same time we are being asked to make significant contributions for people, for the miners who never worked for us.

[Additional written Subcommittee questions and the responses submitted to Pittston Coal Co., Eastern Enterprises, and Templeton Coal Co., Inc. follow:]

EPITTSTON

Kerl K. Kindig President & Chief Executive Officer Pittston Coal Company Direct dial 703.889.6337

August 25, 1995

Honorable Nancy L. Johnson Chairman, Subcommittee on Oversight Committee on Ways and Means U.S. House of Representatives Washington, DC 20515

Dear Congressman Johnson:

Enclosed are the answers of Pittston Coal Company to the additional questions relative to the Coal Act posed by the Subcommittee on Oversight. As you will note from our answers, we continue to believe that the Act, in addition to its other deficiencies, has been very destructive to the collective bargaining process, heretofore the keystone of federal labor policy.

I would like to reiterate the appreciation of our Company for you concern about this illconceived law. Hopefully, your efforts and those of your colleagues will be successful in redressing its obvious inequities.

Very truly yours,

QUESTIONS PRESENTED FOR THE PITTSTON COAL COMPANY

1. What relevance does the 1992 Act have to Pittston's faith in its ability to rely on collective bargaining to resolve issues with its employees?

Madam Chairman, the answer is quite simple, the Act has greatly undermined the collective bargaining process. The 1992 Coal Act represents unprecedented federal intrusion into a private contract, the implications of which carry far beyond the interests of coal companies. The entire system of collective bargaining, which affects many industries, has been compromised. The assumption by Congress of the role of final arbiter in labor disputes will undermine confidence in the collective bargaining process. No employer, or union for that matter, will be able to make concessions in bargaining for fear that what it receives in return will be taken away by Congressional action.

What impact did the 1992 Act have on Pittston's collective bargaining agreement with the UMWA? What added costs did it impose? How?

Because of the Act, important provisions of Pittston's hard fought labor agreement with the UMWA was completely abrogated. This agreement was reached following the direct intervention of the Federal Government in the person of then Secretary of Labor Dole after a very difficult mineworker strike against Pittston Coal Company. The Act had the effect of codifying the concessions made by Pittston Coal as part of its collective bargaining agreement, while negating substantial benefits Pittston Coal received as quid pro quo.

In its 1990 labor agreement with the UMWA, Pittston Coal contractually agreed to make a substantial payment to the UMWA 1950 Benefit Trust and to maintain first dollar medical benefits for its employees through its single employer plan. The Act extends the scope of Pittston Coal's liability to mineworkers who were never employed by Pittston Coal, an imposition that was specifically avoided in the collective bargaining agreement.

Not only must Pittston Coal struggle to fund over \$10 million annually in newly imposed health care costs, it may no longer negotiate over health care cost containment issues affecting pre-1993 retirees. In summary, Pittston Coal's cash flow has been substantially affected and Pittston Coal cannot reinvest in its core coal business to the extent necessary to meet long term objectives all because Congress, in the case of the Coal Act, abandoned collective bargaining in favor of legislative intervention

Please elaborate on the portion of your testimony that describes the alleged windfall that the 1992 Act provided for large, foreign-owned coal companies.

The windfall was the result of a well conceived public relations and legislative plan directed by the BCOA, which is largely comprised of multi-national coal companies. First, in the 1988 National Bituminous Coal Wage Agreement, the BCOA engineered a change in the way miner benefits were calculated from tonnage to man-hours worked, thereby successfully shifting beneficiary costs from larger companies to smaller companies whose operations were more labor intensive. This resulted in huge annual savings for the largest and most profitable companies at the expense of smaller operators. But this formula also caused an artificial retiree's health plan funding crisis. To solve this artificial "crisis" the BCOA supported the ill-conceived Coal Act to further reduce their financial obligations and shift these costs (i) to companies which had left the coal business, (ii) to companies, like Pittston, which had negotiated independent labor agreements, or (iii) to smaller coal companies which could not afford to guarantee lifetime health care for all UMWA retirees.

The BCOA's windfall was augmented by the inability of companies like Pittston, which rely heavily on exports, to pass through the added costs of the additional premiums. Finally, the smaller companies are effectively frozen out as future competitors due to cash flow disparities. The BCOA companies will be able to buy up the coal reserves of former signatories, which are driven out of business by the federally mandated retiree health care costs. Thus, not only is the Coal Act an abandonment of over sixty years of federal labor policy promoting collective bargaining, it is anti-competitive as well.



9 Riverside Road Weston, Massachusetts 02193 Tei 617-647-2300 Fax 617-647-2350

J. Atwood Ives Chairman and Chief Executive Officer

July 24, 1995

Representative Nancy L. Johnson Chairman, Ways and Means Subcommittee on Oversight 1136 Longworth House Office Building Washington, DC 20515

Re: The Coal Act

Dear Chairman Johnson:

I am pleased to respond to your July 10, 1995 letter seeking responses to various questions for the official record of the Subcommittee on Oversight's hearing on the Coal Act. I have already elaborated on some of the issues raised by those questions in my July 7, 1995 letter to you, but I will be more detailed here in response to your specific questions. Your questions are right on the mark and Eastern's responses, as well as those of other companies, will further demonstrate that the Coal Act imposes an unprecedented burden that is both unprincipled and bad public policy.

1. Have you appealed any assignments of employees made by the Social Security Administration? With what result? At what expense?

Eastern's appeal efforts have been two-pronged: they have involved both a blanket challenge on a single ground to all of the assignments made to Eastern and individual challenges on numerous other grounds to over 1,000 of the beneficiary assignments. The process began for Eastern in September 1993 when we received the initial assignments of 2,323 beneficiaries. In October 1993, we were billed for 1,494 of these beneficiaries. Since Eastern had long ago sold its coal operations and simultaneously transferred all of its records, we had no means to confirm whether these individuals had ever worked for Eastern, let alone whether they were eligible for benefits under the Act or properly assigned to Eastern. We realized that a Herculean effort would be required to uncover the rationale for these assignments when SSA repeatedly refused to provide Eastern with the basis for its decisions or with any information that would permit Eastern to evaluate whether the assignment was correctly made, or whether the beneficiary was eligible for benefits. As a result, in order to meet the strict appeal deadlines, Eastern employed a sizeable team of outside and in-house lawyers, paralegals, investigators and other support personnel to determine whether the assignments had been properly made.

As a result of our efforts, which took the better part of a year, we found that hundreds of beneficiaries should have been assigned to other companies whose corporate status and history we researched, at great expense, because SSA considered it too costly and burdensome for the government to do so. Additionally, we determined that numerous beneficiaries were ineligible because the beneficiary was either deceased or did not otherwise meet the eligibility requirements of the plan. In the end, after compiling a database of information containing over 12 megabytes of information (approximately 50 metropolitan area phone books!), Eastern filed individual appeals with SSA from the assignment of 1,079 beneficiaries. These appeals contained detailed analyses and historical information regarding the beneficiaries and the other companies for whom they worked. The appeals together comprised 34 shipping boxes of material transmitted to SSA. This nine month process of developing information and filing the challenges required thousands of man-hours of work by lawyers, paralegals and other support staff and has cost Eastern nearly a million dollars in legal and consulting fees and costs to date! (This does not include litigation and lobbying expenses which have also been enormous). The bill just for shipping the 34 boxes to SSA was over \$2,000!

To date, while SSA has not yet ruled on all of the individual appeals submitted by Eastern, it has already agreed with Eastern's analysis on 53 out of the 112 appeals that SSA has reviewed so far. In addition, SSA has acknowledged that a number of the beneficiaries are ineligible for benefits and therefore should never have been assigned to Eastern in the first instance! While Eastern can derive some satisfaction from the reduction in its liability resulting from its successful appeals, Eastern (and other companies) should never have been required to bear the burden and expense of researching and analyzing these assignments.

In addition to challenging the propriety of individual assignments, Eastern has also mounted a blanket appeal calling into question the propriety of assigning any beneficiaries to Eastern. The basis for our challenge is that EACC (Eastern's former subsidiary, now owned by Peabody Coal Company) is the successor to Eastern's former coal division and should therefore have received all of the assignments made to Eastern based on SSA's own internal guidelines. SSA repeatedly represented that Eastern would receive a decision on its successor company challenge prior to the time the individual miner challenges would otherwise be due. Nonetheless, that was not the case and, as discussed above, SSA ultimately required that Eastern file all of its individual appeals before it would rule on the successor issue.

In the end, SSA denied Eastern's claim that EACC should be responsible for all of the beneficiaries assigned to Eastern. SSA's decision was, and is, completely at odds with the assignment provisions of the Coal Act and with SSA's own internal guidelines and instructions. Notwithstanding SSA's refusal to reassign beneficiaries to EACC, we



have recently learned, through a limited response by SSA to a FOIA request, that SSA has reassigned beneficiaries to successors in other instances nearly identical to Eastern's case. SSA has refused to provide additional evidence of assignments to successors unless Eastern pays SSA up front \$74,000 in "costs"! Eastern has appealed SSA's decision; that appeal has been consolidated with the federal court action now pending in the United States District Court for the District of Massachusetts, discussed in greater detail below.

Finally, and unfortunately, lest it appear that Eastern is nearing the end of the assignment and appeal phase of the Coal Act, a little over a week after the Subcommittee hearings on the Coal Act, Eastern received 413 new assignments from SSA (presumably reassignments from other companies to whom the beneficiaries had been erroneously assigned). Many of these assignments appear to be based on purported employment for a predecessor of Eastern's subsidiary, Midland Enterprises Inc., a marine transportation company that has never been in the coal business, never employed a single coal miner and never signed a single UMWA coal wage agreement. The tenuous connection to Eastern apparently arises from the purchase by Midland of certain barge assets from another company which then ceased its operations. That same company had previously sold certain coal operations to a current BCOA member. This is truly a perverse result of SSA's interpretation of the Coal Act! These new assignments may not only add tens of millions of dollars to the amount of Eastern's liability, but it begins anew the agonizing, time-consuming and expensive appeal process! Moreover, SSA has indicated that this is not the end of the reassignment process, but rather that it is an ongoing process that will continue to result in new reassignments in the future.

2. Do you have any pending litigation under the 1992 Act?

Yes. <u>Eastern Enterprises v. Donna Shalala, et al. and Eastern Enterprises v. Peabody Holding Co., Inc., et al., Civil Action No.93-12372-WF</u> (D. Mass. 1993).

On November 1, 1993, Eastern filed a complaint in Federal District Court in Massachusetts against the Secretary of Health and Human Services and the Trustees of the UMWA Combined Benefit Fund challenging the constitutionality of the Coal Act as applied to Eastern on due process and takings grounds.

Eastern also filed a third party complaint in that action against Peabody Holding Co., Inc. and Eastern Associated Coal Corp. alleging that Peabody and EACC are responsible for any liability Eastern is forced to bear under the Coal Act on account of the transfer of Eastern's Coal Division to EACC in 1965 and the subsequent sale of EACC to Peabody in 1987.



On February 15, 1995, Eastern amended its complaint to add an appeal of SSA's denial of Eastern's blanket appeal on successor company grounds, described above. A hearing on Eastern's motion for summary judgment on its appeal of SSA's decision is scheduled for August 15, 1995.

3. Can you describe what your legal costs have been?

Eastern's legal fees and costs for its outside counsel and support staff covering the administrative challenges, the federal court case and its efforts to obtain a legislative solution by way of an exemption from the Act total approximately \$1.5 million through June 30, 1995. This figure, however, does not capture the huge resources Eastern and its subsidiaries have expended in terms of executive and other in-house staff time devoted to these issues.

4. What is your approximate annual premium liability under the Act?

Eastern's approximate annual premium liability is \$3.2 million for the first full year (October 1, 1993 - September 30, 1994). Eastern's total projected liability based on the original assignments (not including the 413 new assignments or any future assignments) is between \$70-100 million. With the addition of the most recent assignments, Eastern's liability could increase by \$20 million or more and the annual premium could exceed \$4 million or more. As noted above, it is also possible that Eastern will receive additional assignments that will add to its total liability.

5. What steps would you recommend that Congress take to remedy the problems created by the 1992 Act?

Eastern strongly recommends that Congress amend the 1992 Coal Act, not just to "remedy the problems," but to right the injustices and undo the harm caused by that statute. Congress should start with the simple proposition that those who are not responsible for the problem should not pay for the remedy: Reachback companies that did not sign the 1988 UMWA agreement should not be liable for Coal Act payments. Period. This would not affect miners' benefits, since present BCOA companies -- who are the sources of the problem -- will remain responsible for maintaining the funds' viability to pay for benefits that those BCOA companies guaranteed.

Should the Committee conclude that it is not feasible to carve out all reachback companies from the 1992 Act, Eastern urges that basic tenets of justice and fairness require that Congress exempt from the Act those super reachback companies like Eastern that never signed the 1974 and 1978 UMWA agreements, these agreements



being the sources of any possible argument that signatories promised lifetime health benefits to coal miner retirees and their dependents.

I hope you will find the above information useful in determining how best to resolve the many inherent problems with the Coal Act. I think you will agree that the Act is unprecedented not only in its retroactive effect, but also in the outrageous burden it has imposed on companies unfortunate enough to be caught in its web. I know you will try to assist us in obtaining complete relief from this truly unfortunate and ill-connecived piece of legislation. Please let me know if I can provide you with any additional information that will assist you in this task.

Sincerely,

JAI:law

cc: Donna Steel Flynn, Subcommittee Staff Director
Wm. R. McKenney, Professional Staff
Phil Moseley, Chief of Staff, Committee on Ways and Means



HOUSE OF REPRESENTATIVES COMMITTEE ON WAYS AND MEANS SUBCOMMITTEE ON OVERSIGHT

HEARING ON PROVISIONS OF THE ENERGY ACT OF 1992 RELATED TO THE FUNDING AND PROVIDING OF HEALTH BENEFITS OF RETIRED COAL MINERS

Hearings Of June 22, 1995

This Response is Submitted Tuesday, August 01, 1995

Response To "Questions For The Reachback Panels", As Requested By Chairman Johnson's Letter Dated July 10, 1995

Thomas E. Templeton
President, Templeton Coal Company, Inc.

QUESTIONS FOR THE REACHBACK COMPANY PANELS

1. Have you appealed any assignments of employees made by the Social Security Administration? With what result? At what expense?

Answer: Templeton appealed its originally assigned 41 beneficiaries. Our wholly owned subsidiary, Sherwood-Templeton Coal Company also appealed their original 5 assignments. Through appeals with SSA, Templeton has had 14 beneficiaries removed, for a total of 27 remaining assignments. Most of these appeals were successful because we were able to show the miners should be assigned to other companies or they worked for us in non-union capacities. However, since the June 22, 1995 Hearings, SSA assigned us 16 new beneficiaries based on 8 miners, though it remains unclear if all 16 are alive to be assigned. Sherwood-Templeton has had similar appeals experience and is now responsible for 4 beneficiaries after winning 3 appeals and getting 2 new assignments. We have begun the appeals process on all new assignments.

Templeton and Sherwood-Templeton spent \$43,109 in legal expenses preparing the first round of appeals. We have no estimate what the second round will cost. We are unable to determine how many hours our staff spent sorting through 40 year old boxes of dusty records searching for information that might help us.

2. Do you have any pending litigation under the 1992 Act?

Answer: Yes. Templeton and Sherwood-Templeton filed suit challenging the constitutionality of the Coal Act under the "Due Process" and "Takings" Clauses. We were not successful in the U.S. District Court, Southern District of Indiana, and have

filed an appeal in the Seventh Circuit Court in Chicago, Illinois. We firmly believe the 1992 Coal Act to be unconstitutional as it pertains to Templeton Coal Company, Inc. and Sherwood-Templeton Coal Company, Inc..

3. Can you describe what your legal costs have been?

Answer: Through May of 1995, Templeton and Sherwood-Templeton have spent \$214,240 in legal fees, including the \$43,109 for appeals of assignments, but excluding legislative expenses.

4. What is your approximate annual premium liability under the Act?

Answer: Templeton and Sherwood-Templeton paid \$164,790 for the fiscal year ending 9/30/94. We expect to pay \$40,339 in fiscal year 1995, which was a substantial reduction primarily because of credits owed and reduced liability from successful appeals. In 1996 our costs are expected to more than triple. If we are required to pay on all 16 new assignments plus 2 more for Sherwood-Templeton, we will owe 20 months of back premium amounting to approximately \$62,614. In addition, we would pay \$94,633 in regular premiums. After adjusting for \$19,923 in credits we are owed from successful appeals, we expect to pay \$137,325 for fiscal year 1996. Costs could go much higher. We are told SSA will not complete this round of the reassignment process until September 1995. New assignments could further increase our costs. Templeton has always been and hopes to always remain current in its Coal Act obligations.

5. What steps would you recommend that Congress take to remedy the problems created by the 1992 Act?

Answer: Though we support H.R. 1370, we agree with Congressman Hancock's opening remarks saying we should consider legislation that goes further. It is wrong that Templeton pay even one dollar, considering we have not signed a UMWA contract in over four decades.

We support suggestions that legislation relieve all Reachback Companies of all future liability. To be successful, we believe alternatives must (1) remove all future liability imposed upon Super-Reachback companies, (2) be revenue neutral, perhaps by shifting costs back to the companies who made the promises or through use of the surplus, and (3) not effect the security or benefit level of the miners.

Congress should consider that if the relief it passes is not complete and equitable, it will likely face harmed companies seeking relief for years to come. We urge Congress to consider total relief for all Reachback companies.

Chairman JOHNSON. Thank you very much. I appreciate the testimony of this panel.

I look forward to working with you in the months ahead to see if we can create legislation that is fairer to all.

Thank you.

The next panel will be Mr. Trumka, president of the United Mine Workers of America, Chris Farrand, vice president of Peabody Holding Co., and Page Henley, senior vice president of Development, Westmoreland Coal.

Mr. Trumka, if you will start please.

STATEMENT OF RICHARD L. TRUMKA, INTERNATIONAL PRESIDENT, UNITED MINE WORKERS OF AMERICA

Mr. TRUMKA. Thank you.

If I might ask just a procedural question. I listened intently to some of the things you were saying. I heard a number of misstatements. For instance, Mr. Ives said that the money was paid to the union over this period of time. The money was never paid to the union but was always paid into a tripartite trust that his company always had a say in.

Mr. Kendig said that he did not know of any benefit plans as lucrative as the plan that is under question here, and all of his

employees received those exact benefits.

My question is can, after reviewing the transcript, we submit corrections or at least our side of the story with those gross misstatements?

Chairman JOHNSON. You certainly will be able to do that and we

encourage you to do that. We want the record to be straight.

When you do that, I want you to look at not only the benefits but the copaid structure. Because the reason that I am asking those questions is that the Employee Benefit Research Institute which looks at these plans has written about the UMWA benefits and they say the absence of significant beneficiary cost-sharing requirements, they say that two reports comparing the UMWA benefits with those offered under other large group plans highlight both the generosity of the UMWA benefit package and the absence of significant beneficiary cost-sharing reforms. These features remain essentially unchanged under the 1992 Act.

They go on later that the lack of an annual deductible premium contribution requirements, those kinds of things, plus the unusually broad definition of dependent coverage are unique to those

plans. At least that is my understanding.

Mr. TRUMKA. We will be happy to respond to each of those.

When comparing those benefits, please understand that over the years mine workers' beneficiaries have fore-gone pension payments. Their pensions are far lower than anybody else's pensions, so they could have a health care benefit. When you look at that, please compare the pension benefits.

We will be happy to respond to that in absolute detail, because I think when you look at it, you will understand that these are promises made to these people by the White House a number of years ago, and I think they have earned these benefits and we will

do everything we can to make sure they maintain them.

Madam Chairman, and Members of the Subcommittee, thank you for the opportunity to appear on behalf of nearly 100,000 retired miners and survivors who receive their medical insurance coverage from the UMWA.

Chairman JOHNSON. Before you get started, I need to clarify an

earlier statement.

You cannot offer rebuttal remarks that will be included in the record, but we will be submitting questions to everyone who appeared and we will submit a broad enough question so that you will be able to offer whatever information you think is relevant and the answers to the question do become part of the record.

Mr. TRUMKA. Will we have sufficient time after we get a tran-

script of this hearing?

Chairman JOHNSON. The transcript will be ready in about 10 days and you are welcome to come and read it. We do not give out copies. Then you will have time to submit the answers to questions at your pace.

Mr. TRUMKA. The transcript will be ready in 10 days and we can

come read the transcript?

Chairman JOHNSON. It will be transcribed in 10 days and available.

Mr. TRUMKA. Can we copy it ourselves?

Chairman JOHNSON. Apparently not. You can come read it.

But I am not sure that you need to go over it in that detail. I think the things that you want to say, we will ask you questions, we want to be sure that you have a chance to put on the record everything you think is relevant, and I think that is probably the more important fact.

Mr. TRUMKA. I sat here for a very short period of time and I listened to a number of misstatements, and I do not want the Committee to be misled because of a misstatement. I heard a number of them, and we would like to correct them. If we cannot do

anything other than read the transcript, we will do our best.

Madam Chairman and Members of the Subcommittee, thank you for the opportunity to appear on behalf of nearly 100,000 retired miners and survivors who receive their medical insurance coverage from the UMWA combined fund. The Coal Industry Retiree Health Benefit Act which established the Miners Health Benefit Fund was enacted in 1992 with bipartisan support and was signed into law by President Bush after a series of negotiations with the Bush White House.

It averted what would have been the end of a nearly 40-year-old health care system for one of our Nation's most vulnerable populations. At the time of the act's passage, the average beneficiary was 76 years old and more than half were elderly widows. Most of these retirees worked their entire lives in the mines under conditions that average Americans would find appalling.

Many still suffer from the debilitating effects of mine accidents or respiratory problems caused by exposure to coal dust. Cutting off health insurance benefits for this group of Americans was unthinkable to Congress, and it acted wisely to fashion a compromise that has provided real health security to tens of thousands of elderly

retirees and widows.

In addition to discussing the status of the coal act and its effect on various groups, I would like to discuss H.R. 1370, a bill that would reduce the medical payments of a select group of companies in the combined fund based on the fund's short-term surplus.

H.R. 1370 would result in the one thing that everyone agrees should not happen, including one of its sponsors, Representative Hancock. I was very pleased to hear you reiterate that you did not want the elimination of health care benefits for the retirees who were promised those benefits and who are now too old and too infirm to find alternative health insurance coverage.

Simply from our perspective, H.R. 1370 is a dagger very pointed and sharp pointed straight at the heart of the coal act and at the welfare of the combined fund's beneficiaries. Recent information from GAO and a well-respected accounting firms, details the

precarious financing of the Miners Medical Fund.

The studies make it clear that eliminating all but 10 percent of the surplus as has been proposed in the Myers-Hancock bill would cause the fund to become insolvent almost overnight. If this occurs, the combined fund trustees will be left with the same impossible dilemma that confronted the trustees for the old 1950 and 1974 health funds; that is, a mandate to provide a specific level of benefits but insufficient income to pay for them.

When this happened in 1991, doctors, hospitals, pharmacies, and other medical service providers went unpaid until eventually the trustees concluded that they had no choice but to cut benefits.

Madam Chairman, I spent each and every day during that period of time working with the trustees, working with hospitals, working with beneficiaries, small pharmacies, ma and pa pharmacies, trying to prevent the cutoff of those benefits. In the end, the benefits were not cut, but only because the court stepped in and forced the employers to sharply increase the amount of their contribution, and because the following year Congress passed the coal act.

The studies prove another important point and that is that the current surplus is temporary and is due in large part to the rate at which the Federal Government was, and I reemphasize the word, was reimbursing the fund for Medicare services. However, in July 1994, the contract with Medicare was renegotiated and the

rate was reduced by 25 percent.

I want to emphasize that the surplus is not the result of premium payments made by any companies that have been assigned benefits, neither reach-back companies nor BCOA companies.

The bottom line is that the Myers-Hancock bill will greatly exacerbate the fund's financial flight and lead inevitably to a situation

where benefits will once again be threatened.

When it passed the coal act, Congress was keeping the commitment made by President Truman, who, after taking control of the mines during a nationwide strike, negotiated a settlement with the coal operators that included the creation of the UMWA Welfare and Retirement Fund. Congress must not now go back on that promise.

Many of the major companies supporting H.R. 1370, in fact, its major beneficiaries, dumped their own retirees less than a decade ago on companies that were still bargaining with the UMWA. In effect, the bill rewards the companies that promised their employ-

ees lifetime medical benefits and then walked away from that promise, thus causing the crisis that led to the coal act's passage.

I am absolutely certain that Congress will not want to grant this group of companies what amounts to a significant tax break at the cost of medical care for retired coal miners.

Importantly, H.R. 1370 would also make it impossible to consider the claims of the small number of companies that may have legitimate problems meeting their full premium obligation under the act. If premium relief is to be considered, it should be based on provable hardship, not on the claim that an employer should be able to lawfully unload its retiree health care liabilities on others

despite having the financial ability to continue paying.

Madam Chairman, I am ready to work with the Subcommittee to address the problem of small companies that might have legitimate problems meeting the premium obligations under the act. The UMWA has no reason, and I emphasize no reason, to want any company pushed into bankruptcy by the act, but I believe that such cases are few and far between, and we should be careful not to overreact to suggestions that legions of small companies are being forced out of business because they must now pay for retiree health care.

As the Subcommittees moves forward with its deliberations over the coal act, I urge you to place yourself in the role of fiduciaries of the Miners' Health Fund and that you take extra special care that the security of the retirees is not put in jeopardy.

Thank you, Madam Chairman. [The prepared statement follows:]

Statement of Richard L. Trumka International President United Mine Workers of America

to the Subcommittee on Oversight Committee on Ways and Means

U.S. House of Representatives June 22, 1995

Madam Chairwoman and members of the Subcommittee, thank you for this opportunity to appear on behalf of the nearly 100,000 retired miners and survivors who receive their medical insurance coverage from the UMWA Combined Fund.

The Coal Industry Retiree Health Benefit Act, which established the miners' health benefit fund, was enacted in 1992 with bipartisan support and signed into law by President Bush. It averted what would have been the end of a forty-year-old health care system for one of our nation's most vulnerable populations; at the time of the Act's passage, the average beneficiary was 76 years old and more than half were elderly widows.

Most of these retirees worked their entire lives in the mines, under conditions that average Americans would find appalling. Many still suffer from the debilitating effects of mine accidents or respiratory problems caused by exposure to coal dust. Cutting off health insurance benefits for this group of Americans was unthinkable to Congress, and it acted wisely to fashion a compromise that has provided real health security to tens of thousands of elderly retirees and widows.

In addition to discussing the status of the Coal Act and its effect on various groups, I would like to discuss H.R. 1370, a bill that would reduce the medical payments of a select group of companies in the Combined Fund, based on the Fund's alleged surplus.

H.R. 1370 would result in the one thing that everyone agrees should not happen, and that is the elimination of health care benefits for the retirees who were promised these benefits and who are now too old and too infirm to find alternative health insurance coverage. Put simply, H.R. 1370 is a dagger pointed straight at the heart of the Coal Act and at the welfare of the Combined Fund's beneficiaries.

Recent information from both the General Accounting Office and a well-respected accounting firm details the precarious financing of the miners' medical fund and suggests that eliminating all but 10% of the surplus--as has been proposed in the Myers-Hancock bill--will cause the Fund to become insolvent almost overnight.

If this occurs, the Combined Fund trustees will be left with the same impossible dilemma that confronted the Trustees to the old 1950 and 1974 health funds—a mandate to provide a specific level of benefits but insufficient income to pay for them.

When this happened in 1991, doctors, hospitals, pharmacies, and other medical service providers went unpaid, until eventually the trustees concluded that they had no choice but to cut benefits. In the end, benefits were not cut, but only because the courts stepped in and forced the employers to sharply

increase the amount of their contribution and because the following year Congress passed the Coal Act.

According to the General Accounting Office, which in June 1994 projected a continuing surplus, "it now appears that annual deficits—instead of surpluses—are likely to occur, which would erode the current surplus over time." The current surplus of approximately \$114 million will be necessary to cover annual operating deficits, which, according to the GAO, may occurr as soon as this year.

It is important to keep in mind that for the first 18 months of the Combined Fund's existence, a surplus accumulated largely due to the rate at which the Health Care Financing Administration had contracted to reimburse the Funds for Medicare services. However, when the risk contract with HCFA expired in July 1994, it was renegotiated and reduced by nearly 25%.

According to the GAO, which had used the old HCFA contract rate in its June 1994 forecast, the new rate will not result in a surplus, and as a result, deficits are likely to occur. A projection of long-term revenue and expenses conducted in March by the firm of Ernst and Young found that the most likely case—which it called its baseline projection—is for the Fund to begin experiencing annual operating deficits in 1995. By 2003, the study predicts, the Fund will face a negative balance of \$3.5 million; in 2004 the deficit will grow to almost \$40 million.

Although the Committee will have an opportunity to question actuaries on both sides of the issue, it is important to understand that the projections relied upon by the Funds and by the GAO were based on medical cost trends that have been accepted by the Ways and Means Committee in its Medicare deliberations and should therefore be an acceptable basis on which to form a conclusion about the Fund's financial condition.

The bottom line is that the Myers-Hancock bill will greatly exacerbate the Fund's financial plight and lead inevitably to a situation in which benefits will once again be threatened. When it passed the Coal Act, Congress was keeping the commitment made by President Truman, who, after taking control of the mines during a nationwide strike, negotiated a settlement with the operators that included the creation of the UMWA Welfare and Retirement Funds. Congress must not now go back on that promise.

In decisions upholding the constitutionality of the Coal Act, numerous federal courts have cited the government's role in the establishment and continued existence of the miners' medical care program. In one recent case, the court wrote:

"Given the fact of continued provision of health care to UMWA represented retirees, as well as the pervasive nature of the government's regulation of virtually every facet of the coal industry, multi-employer benefit funds in general, and the UMWA Funds in particular, any expectation that any Last Signatory Operator may have had that it could freely and forever walk away from its responsibilities to UMWA retirees, and dump its share of the liabilities on the operators that were still contributing to the UMWA 1950 and 1974 Benefit Plans, would be patently unreasonable." Holland, et al. v. Kennan Trucking Co., et al., Civ. No. 2:93-1223 (S.D. W. Va. March 15, 1995).

At the time of the Act's passage, we faced the imminent collapse of the multi-employer trust funds, known as the 1950 and 1974 Benefit Trusts, that provided health care benefits to over 120,000 retired coal miners and their survivors. Skyrocketing health care costs and a steady decline in the number of contributing companies had resulted in a deficit of over \$100

million, and the likelihood that benefits would be cut off when the then-current UNWA-BCOA agreement expired, on February 1, 1993

By 1992 fully two-thirds of the beneficiaries in the UMWA Funds had worked for companies that were no longer contributing toward their benefits. The signatory companies—those companies with whom the UMWA still bargained—had employed only 30% of the retirees covered by the Funds. The other 70%, known as orphans, had been employed by companies that were no longer signatory to a UMWA agreement. But that did not mean that these employers were out of business or unable to continue paying for their retirees' medical coverage.

The compromise that was worked out between the Bush White House and the Congress followed the recommendations of the Coal Commission, the panel established by Labor Secretary Elizabeth Dole to examine and make recommendations concerning the financial crisis facing the UNWA Funds.

The basis for the Commission's recommendation is summarized in its introduction: it says "retired coal miners have legitimate expectations of health care benefits for life; that is the promise they received during their working lives and that is how they planned for their retirement years."

That conclusion framed the congressional debate that followed. It echoed what the courts had said and what the miners have always believed, that upon retirement they are entitled to health care for life. To guarantee that this commitment would be honored, the Commission recommended that a statutory obligation to contribute should be imposed on current and former signatories to the National Bituminous Coal Wage Agreement (NBCWA).

Adopting the Commission's conclusion that coal companies that had signed the 1950 or later NBCWA bear the responsibility for providing lifetime health benefits to their own retirees, the final compromise looked back to 1950 to find companies to whom current beneficiaries could be assigned.

The funding mechanism Congress established guarantees that only those companies that signed collective bargaining contracts that promised retiree health care would be liable for premiums under the Act. In many respects, the Act represents a codification of the contractual commitment that former signatories once voluntarily undertook.

Many of the major companies supporting H.R. 1370-in fact, its major beneficiaries--dumped their own retirees less than a decade ago on companies that were still bargaining with the UMWA. In effect, the bill rewards the very companies that promised their employees lifetime medical benefits and then walked away from that promise, thus causing the crisis that led to the Coal Act's passage. I am certain that Congress will not want to grant this group of companies what amounts to a significant tax break at the cost of medical care for retired coal miners.

H.R. 1370 would also make it impossible to consider the claims of the small number of companies that may have legitimate problems meeting their full premium obligation under the Act. If premium relief is to be considered, it should be based on provable hardship, not on the claim that an employer should be able to lawfully unload its retiree health care liabilities onto others despite having the financial ability to continue paying.

Madam Chairwoman, I am ready to work with the Subcommittee to address the problem of small companies that may have legitimate problems meeting their premium obligations under the Act. The UMWA has no reason to want any company pushed into bankruptcy by the Coal Act. But I believe that such cases are

few and far between, and we should be careful not to overreact to the suggestion that legions of small companies are being forced out of business because they must now pay for retiree health care.

As the Subcommittee moves forward with its deliberations over the Coal Act, I urge you to place yourselves in the role of fiduciaries of the miners' health fund and that you take special care that the security of the retirees is not put in jeopardy.

Chairman JOHNSON. I regret that we are going to have to break for half an hour. We have 7 minutes left in this vote and there are four 5-minute votes.

When we come back we will through questioning give you a chance that will fit in better. I think rather than getting halfway through the next statement, it is probably better to lay over the next two statements until we return.

The hearing will be in recess for half an hour.

[Recess.]

Chairman JOHNSON. The hearing will resume. We probably will be interrupted with one more vote, but we are going to start back on our track here.

Mr. Farrand.

STATEMENT OF CHRIS FARRAND, VICE PRESIDENT, COR-PORATE DEVELOPMENT, PEABODY HOLDING CO., ST. LOUIS, MISSOURI; ON BEHALF OF BITUMINOUS COAL OPERATORS OF AMERICA

Mr. FARRAND. Thank you, Madam Chairman. I am vice president of Peabody Holding Co., but I am here representing the Bituminous Coal Operators Association today and, as you know, BCOA is a multiemployer group that represents certain producers of coal in the U.S.

My company has two subsidiaries that are members of BCOA, Peabody Coal Co. and Eastern Associated Coal Corp. I would ask the Committee's permission to submit my written statement for the record and make a few brief comments, if I may.

I would like to address the questions that were raised today about the crisis, it was called, whether the crisis was real in 1992, and what choice or choices the Congress and the Bush administration had when they passed the Coal Mine Retiree Health Benefits Act. I would like also to address the comments that were made earlier about the so-called windfall to BCOA companies.

The crisis was indeed very real from our standpoint and I am going to give a brief recitation of why I think that is the case. A promise was made, it has been referred to several times today, that really began back in 1950, and through a succession of labor agreements, the promise was maintained. In fact subsequently the courts ruled that it was in fact a promise, but the court's rulings did not affirm any methods of keeping the promise.

There was no funding mechanism defined on a permanent basis to support the promise that these certain closed groups of coal mine retirees and their dependents would receive retiree health care benefits for life. Under the 1988 National Bituminous Coal Wage Agreement, the situation was exacerbated. The funding base for the benefit trust, was depleted, not, I might add, because the funding mechanism switched from tons to hours worked.

If I can digress for a minute, Madam Chairman, since you asked the question, in 1988 the fund was a defined benefits plan and the courts ruled that the signatories—who were more than just the BCOA companies, but the entire body of signatories to the 1988 agreement—would have had to put up contributions in any case to fulfill the promise for at least that term that benefits would be forthcoming.

It is irrespective of whether we did it on the basis of hours or tons; the same amount of money had to be put forth by the same signatory group. It was a question which members of the group would pay how much, but nevertheless the tons versus hours funding mechanism itself did not create the crisis.

What created the crisis was the fact that the funding base in total had shrunk because you had fewer signatory companies. You had a number of companies who had either left the coal business or, frankly, refused to continue to pay. They did not feel they were obligated to fulfill the promise and therefore refused to pay into the funds.

As this funding base shrunk, the obligation on individual producers, whether it is tons or hours, grew. It was like a downward spiral, Madam Chairman, because, as the premiums rose per unit of output, whether you call it hours or tons, there was an incentive or an impetus for more and more companies to get off and we were heading off a cliff, frankly, at the end of the 1988 agreement.

Looking to the end of that agreement, which expired in February 1993, we knew there was no way that signatory companies could continue to pay premiums and remain in business. I will put some

parameters on that.

At the end of the 1988 agreement, each of us was paying a combined premium of \$3.67 per hour worked by each employee. What that meant was that we were paying an increment of about 25 percent of our hourly wages not for our employees', but mostly for somebody else's retirees' benefits.

For example, our two subsidiary companies were paying premiums that amounted to 16 percent of the total premiums paid to the funds. We only have about 4 percent of the beneficiaries in that fund, so we were paying \$3 to pay for somebody else's retirees for every \$1 we were paying for our retirees.

During the term of the 1988 agreement, the signatories to that agreement put \$1.1 billion into the two benefit trusts and the funds staff have calculated that about \$600 million of that \$1.1 billion was to pay for companies who were no longer paying for their own retirees.

In effect, if you put yourself in our position at the time, we were subsidizing our competitors. Many of these companies are still in the coal business competing with us every day. To put that \$3.67 number into perspective, at the productivity rates in 1992, for a typical Eastern underground mine, it is about a dollar a ton cost disadvantage in a market that sells coal based on pennies a ton.

The fact remains we could not as producers have agreed to another National Bituminous Coal Wage Agreement under the conditions we had in the 1988 agreement. We simply could not do it.

The Bush administration had a foretaste of this problem as a result of the 1989 Pittston strike and out of that strike, as has been mentioned earlier, came the Dole Commission. The Dole Commission looked at the problem and said we have three choices to deal with this. One, we can make all of the current and former signatories pay into a fund on a shared basis. But that begs the question of who is going to get which share, and they decided that wouldn't work.

A second option was to apply an industrywide tax, and we have a history of that in our industry. We have the abandoned mine land fee, which is an industrywide tax, to pay for the liabilities of some other companies which are no longer in business, and we have the black lung excise tax, which is also an industrywide tax, to pay for abandoned orphaned beneficiaries who are determined to have black lung disease.

The third choice, of course, was—and it was the administration's choice, which Congress adopted, which was to say that the people who made the promise or their successor corporations should be held accountable for the benefits of the people who retired from either those entities or their predecessor entities, and they should do it individually, and for the true orphans we will find other sources of funds.

The other source of funds was the surplus in the 1950 pension trust. So, we found a surplus which, in essence, the BCOA companies put up, and used these funds to deal with the orphans and gave the reach-back companies the obligation to pay for their own retirees only. That was the solution.

They faced a dilemma and they came up with a solution that was the fairest and simplest of the three options. I am not suggesting that all are perfect or any of them are perfect, but they chose an option that stands on the principle. The principle is that if there are retiree benefits promised, they should be paid by their former employees and not by the people who did not employ them, many of whom must compete against them.

The other option, of course, was to let the system collapse. In that case there would have been, I think, Mr. Trumka would agree, probably a long and bitter strike. We did not feel that was an option either. So, the choice that Congress selected, imperfect though it may be, was the fairest and simplest of those available at the time.

Madam Chairman, I want to address one other issue, which is the windfall concept that was spoken of this morning. I am sorry we do not have the nice colored chart that was up here earlier—

Chairman JOHNSON. We have it individually.

Mr. FARRAND. If you have copies of it, I would like to address it, if I may. The chart suggests that, it was a BCOA created crisis. First, numbers associated here are not reflective of BCOA companies, but of all the companies who signed the 1988 agreement. There were only 14 companies in BCOA and over 300 companies signed the agreement. The most important point I would like to make about this chart is the fact that the so-called savings that have been mentioned, \$385 million, includes about \$450 million associated with the pension trusts, not the benefit trust, not health care, but pensions.

The reason why the 1988 signatories were no longer paying pension fund premiums is that the pension fund had become fully funded. In fact, it had a surplus and we are now using that surplus to deal with health care benefits for orphaned miners, orphaned retirees.

We had, in essence, advance paid the fund. It was fully funded— Chairman JOHNSON. Would you clarify for me what amount of the \$384 million you were putting in your pension fund or the companies were putting in their pension fund? You are saying that this

combines health and pension payments.

Mr. FARRAND. What is reflected on this chart is a combined payment amount including the pension fund, and my point is simply this. The pension fund payments disappeared not because anybody shirked their duties. In fact, it had been fully funded. In fact, it had been overfunded.

I would argue, I guess, that those signatories of 1988, of the 1988 agreement, were in effect paying the pension obligations of a whole lot of companies who had dumped their retirees into the fund, and we took care of those pension obligations, and now we simply argue that they ought to at least pay their retiree health benefits. We have taken care of their pension obligations. So, I question the validity of the assumption that we saved all this amount of money.

To sum that up, I would argue that in our industry, like all commodity prices, the coal price has gone down in real terms dramatically, over the last 10 years, about 50 percent. Had we continued to fund, or I would argue continued to subsidize the people who were no longer paying their obligation in those combined funds, we could not remain in business. That was the crisis. Nobody could afford to sign an agreement similar to what we had in 1988 and remain a competitive, effective company in the coal business. Congress recognized that. They chose the best of the three options available, and that is what we have today.

I will be happy to respond to any questions you have.

[The prepared statement follows:]

STATEMENT OF CHRIS FARRAND VICE PRESIDENT, CORPORATE DEVELOPMENT PEABODY HOLDING COMPANY, INC. ON BEHALF OF BITUMINOUS COAL OPERATORS' ASSOCIATION

Madame Chairman and members of the Subcommittee, my name is Chris Farrand. I am Vice President for Corporate Development of Peabody Bolding Company, Inc. I am appearing on behalf of the Bituminous Coal Operators' Association (BCOA), the multi-employer bargaining association representing a group of employers in the bituminous coal industry. Two Peabody Holding Company subsidiaries, Peabody Coal Company and Eastern Associated Coal Corporation, are members of BCOA.

A Brief History of the Events Leading to the Coal Industry Retiree Benefit Act of 1992 ("Coal Act")

I understand a representative of the UMWA Health and Retirement Funds will provide the Subcommittee with a history of evolution of retiree health care in the coal industry. Revertheless, a brief history is necessary to understand the predicament facing our industry, Congress and the Bush Administration when the Coal Industry Retiree Health Benefits Act was passed in 1992.

The provision of health benefits in the coal industry dates back almost 50 years, when the government seized the nation's mines and imposed a settlement to a labor dispute. The agreement between President Harry Truman and John L. Lewis, then president of the United Mine Workers of America (UMWA), resulted in the establishment of a system for providing health care benefits to both active and retired miners. This system was incorporated into the 1950 labor agreement. The 1950 Benefits Plan and a second fund called the 1974 Benefits Plan were later established as the multi-employer mechanisms through which these benefits were funded. Provisions for retiree health care benefits were included in every subsequent national labor agreement between the union and the industry.

In essence, the successive labor agreements had perpetuated the inherent promise made by President Truman, but the payment mechanism underpinning that promise was negotiated on a contract by contract basis.

However, in recent years, especially between 1988 and 1992, the funding base for the 1950 and 1974 Plans deteriorated badly as many companies left the business or just refused to pay.

Meanwhile, the courts in several different actions confirmed that a promise of lifetime benefits had been made, but they did not affirm a payment mechanism for hidiling that promise. In what can only be called extraordinary interpretations of contract law, the courts imposed upon the remaining signatories to the 1988 National Bituminous Coal Wage Agreement higher and higher premiums to cover the shortfalls in the Benefit Plans. As the premiums rose, so too did the impetus for more employers to leave the plans. More beneficiaries in the multi-employer funds became "orphaned" to be supported only by the remaining companies who were signatory to the 1988 Labor Agreement.

As an example, by the time the Coal Act passed in 1992, two of Peabody Holding Company's subsidiaries, Eastern Associated Coal Corp. and Peabody Coal Company were paying a total of 16 percent of all the premiums paid into the Funds, but only 4 percent of the beneficiaries in the Funds had retired from the two companies and their predecessors.

This "crisis" was not manufactured by BCOA companies. Rather, as the premiums continued to rise, fewer employers could justify paying them and remain in business. With this "snowballing" effect, the Funds became ominously known as the "Last Man's Club." Collapse of the multi-employer funding system was inevitable.

By 1992, with impending expiration of the National Bituminous Coal Wage Agreement (MBCWA), the funding mechanism had deteriorated even further as more companies had dumped retirees into the Funds. Of the \$1.1 billion contributed for health benefits by 1988 signatory companies during the term of the 1988 labor agreement, over \$600 million was for retirees of companies that were no longer making payments into the Fund. Left unresolved, this issue would have made renewal of the NBCWA impossible for

one simple reason: 1988 signatories could not afford to continue to pay for the benefit costs of others companies' retirees and, in order to survive, they were prepared to end their relationship with the Funds.

In 1992, BCOA employers were paying a premium of \$3.67 per hour per worker, not to their employees or even their retirees, but to a Fund to pay benefits largely for someone else's retirees. In a very competitive industry such as ours, the operating cost differential associated with these contributions made continuation of that system untenable. The contention that the 1988 signatory companies received a "windfall" as a result of the Act is simply incorrect.

At issue, of course, was the fate of the 118,000 beneficiaries if the system and the funding base for their health care benefits collapsed.

In 1988, as a result of a protracted strike against Pittston Coal Company by the UMWA primarily over this issue, Secretary of Labor Elizabeth Dole created a special commission to seek a long-term solution to the coal mine retiree health care issue. The Dole Commission recognized the dilemma and offered three possible solutions:

- 1. Past signatory employers could pay for their own retirees.
- 2. Current and former signatories could share the cost of benefits.
- An industry wide tax could be assessed against all current coal operators.

Of the three choices identified by the Dole Commission, the funding mechanism selected by Congress and the Bush Administration was the simplest and fairest. The 1992 Coal Act, as a matter of principle, assigned responsibility for retiree benefits to former employers and related companies of the retirees, not to companies that did not employ them.

The Coal Act is Working Reasonably Well

The Coal Act is essentially working as envisioned by Congress. It should be noted that the Combined Benefit Fund created by the Act encompassed a closed group of beneficiaries whose average age is now 73. In fact, the number of beneficiaries has decreased by 20 percent since implementation due to the age of the population, and there are now approximately 95,000 beneficiaries remaining in the Combined Fund.

Also, it should be noted that the health care cost containment measures required by the Act have been implemented, resulting in a more efficient and cost effective system. The rate of increase in per capita health care costs has slowed, despite the increasing average age of the beneficiary population.

As a result of the assignments by the Social Security Administration (SSA), the number of orphan beneficiaries in the Funds - those whose former employers either refused to pay or were thought to be no longer in business - decreased from 74,000 before the Act, to less than 28,000 currently. That is because the number of these so-called orphans were in fact retirees from companies still in business -- many still in the coal business -- and the beneficiaries have been assigned to them accordingly.

It should also be noted that the Coal Act provided a process for appeal of incorrect assignments. Some 175 companies have already been relieved of liability as a result of the appeals process, which is continuing.

The underlying principle of the Act is that employers should pay for their own retirees, and retiree benefits should not be subsidized by other companies, especially those in the same business.

As a result of the Act, the cost of health care benefits for this closed group of beneficiaries has improved. Moreover, no reachback company is

paying anything more than a per capita charge for its own former employees and dependents.

Finally, the Second and Sixth Circuit Courts of Appeal have upheld the Constitutionality of the Act.

H.R. 1370

H.R. 1370, a bill recently introduced, proposes a moratorium on payment obligations for a select group of so-called "reachback" companies whenever there is a cash surplus of 10 percent or more in the Combined Benefit Fund at the end of any year.

As a result of the initial assignments by the Social Security Administration, responsibility for per capita premiums covering 85 percent of the beneficiaries in the Combined Fund were assigned to just 25 companies, most of which are very large corporations. Of the remaining companies assigned beneficiaries under the Act, 186 companies pay less than \$25,000 per year and 132 pay less than \$10,000 per year.

Under H.R. 1370, 10 of these 25 largest companies would be excused from paying premiums whenever a cash surplus exists in the Combined Benefit Fund. These 10 companies now contribute more than \$42 million annually to the Combined Fund. These contributions would have to be replaced by funds substantially derived from other companies' contributions, or from the Pension Fund or from pre-payments from the Medicare system. In other words, health care costs for 19,000 beneficiaries of these 10 large companies would have to be partially, if not wholly, subsidised by other companies.

A shortfall of \$42 million is 25 percent of the premium contribution base of the Fund and is a very serious shortfall that would accelerate the prospect of a deficit in the Fund. Not only can the Combined Benefit Fund not afford relieve this amount of premium payments, to do so would be grossly unfair to the companies which would be forced to continue to pay, especially those who are in competition with many of the same companies who would be relieved of their obligations.

BCOA is also concerned about the provision in HR 1370 which would calculate the annual surplus in the Combined Fund on a cash basis, rather than an accrual basis. As indicated earlier. H.R. 1370 excuses certain companies of premium payments whenever there is a cash surplus of 10 percent or more at the end of a year in the Combined Fund. This measurement of a surplus in the Fund ignores the 60 to 90-day backlog of claims payable at the end of a given period. Without the continued premiums from the excused companies to help pay these backlogged claims, the Fund would immediately face cash flow difficulties.

If the Social Security System, which currently is well funded, were to adopt this same approach, in which contributions from employers and employees would be excused in any year after the fund had a 10 percent cash surplus, the System would soon collapse. Yet that is exactly what is being proposed in H.R. 1370 for the Combined Benefit Fund.

Projections for the Combined Fund

Ernst and Young has recently performed an independent actuarial analysis of the financial condition of the Fund. The actuary, Mr. Guy King, has concluded that the current surplus in the Fund is temporary and not large from an actuarial standpoint. Moreover, Mr. King projects that the Fund may be in a deficit position by 2003. GAO has subsequently supported Mr. King's projections.

Subsequent to Mr. King's analysis, the Federal District Court for the Northern District of Alabama overturned the initial per capita premium rate set by the Department of Health and Human Services. This ruling will result in a reduction in premiums of as much as 10 percent for all employers who contribute to the Combined Benefit Fund, and, if upheld on appeal, will further reduce the prospects for any future surpluses in the Combined Fund.

Chairman JOHNSON. I have to go vote, but I wanted you to finish. It will take me about 7 minutes and I will recess the Committee for 7 minutes, but I expect to be back promptly.

Mr. FARRAND. I have already missed my flight. Fine.

[Recess.]

Chairman JOHNSON. The hearing will reconvene. Some of my colleagues are on their way, but I think we will proceed without them and they will join us late.

Mr. Henley.

STATEMENT OF R. PAGE HENLEY, JR., SENIOR VICE PRESIDENT OF DEVELOPMENT, WESTMORELAND COAL CO., PHILADELPHIA, PENNSYLVANIA

Mr. HENLEY. Thank you, Madam Chairman. Recognizing that I am tail-end Charlie of a long day, I would like to submit my written remarks for the record—

Chairman JOHNSON. Your testimony, as everyone else's, is

included in the permanent record.

Mr. HENLEY. My name is Page Henley. I am senior vice president of development for Westmoreland Coal Co. Westmoreland is the Nation's oldest independent coal company. It began its operations in 1854 and as you would expect over the years has had quite a number of employees, many of whom are currently retirees under the United Mine Workers BCOA agreement.

The other point I would like to make is that Westmoreland, while a signatory company to the National Coal Wage Agreement since 1950, is not today a member of the Bituminous Coal Operators Association. We have in the past been members of BCOA, but today we negotiate with the United Mine Workers

through a separate organization and agreement.

We are vitally interested in this subject because like the Peabody group of companies, \$3 out of every \$4 we paid over a number of years went to pay for retirees of companies other than Westmoreland.

Today, Westmoreland, with approximately 650 hourly workers is paying for 2,213 former employees who are now retirees of our company. If you were to quadruple that figure, you would get an idea of what the 650 employees would have to generate in the way of income for our company to cover the costs of not only our own retirees, but the other industry retirees which we were paying for

prior to the passage of the act.

We believe that the act restored what should have been present all along, and that is an sense of fairness and equity. You have heard a great deal about fairness today and you have heard from a number of situations which I would agree with the presenters create unique hardships. However, there is a process for working out those hardships, and one of those today, the Buchanan Coal Co. operation, has apparently received an exemption from the act. The act is working. I believe that is the proper recourse for those persons and companies who have had an unfair situation thrust at them by the act.

What I would like to emphasize is, as Mr. Farrand said, many of the companies that are complaining about the act are companies that are still in the coal business, still competing with us, and are very glad to have us pay for their retirees. That is a nice thing to do, and we believe in being beneficent, but we cannot do that anymore.

Ås a practical matter, Westmoreland Coal Co. is a company experiencing significant financial distress. In 1994 Westmoreland sought protection under chapter 11 of the U.S. Bankruptcy Act to enable it to be protected from its creditors while it sold a large property it owned in the State of Kentucky to enable it to pay off its significant debt.

We have come out of Chapter 11 and are currently in the process of restructuring the company to be able to continue to compete in this business. However, with the costs that we are paying through the combined fund and the other funds, today Westmoreland Coal Co. is, in effect, being operated to pay health benefits for its retirees.

We are not here to seek sympathy, but I think it is a point that not all of the companies that are benefiting from the fairness and equity which this act reinstituted are companies that are large, wealthy and owned by a diverse group of owners. Westmoreland is an American publicly held company.

We would call upon the Committee to carefully examine the act and the impact of the act on this industry. I think the Committee and all of the speakers here, regardless of their viewpoint on the act, have said that we owe the retirees their promised retirement.

The medical program under the act was instituted a number of years ago when views on medical insurance and medical care for persons was entirely different than it is today. These men, for the most part, that are the retirees worked for many companies, built this industry, made a lot of money for the companies that are currently paying for their retirees and a lot of companies who are now complaining about paying for their retirees. There is no question but that these people and their dependents are due the moneys they receive. The issue is how in equity and fairness should those moneys be paid to fund those programs.

We say that this act did restore a proper balance. It says in very simple terms that if you hired someone to work for you, you were a signatory to the Bituminous Coal Wage Agreement since 1950, and you are capable of making those payments, these are your people, and you should pay for them. That is all this act really does, bottom line.

For those companies who are now our competitors to come in and say that is not fair because for some other reason they have managed to remove themselves from this obligation is really an effort to achieve a competitive advantage, and this is nothing more than a standard economic battle. We recognize our obligation to take care of our employees and we will run our company in such a way as we will honor that obligation. We just do not think it is fair that we should be required not only to honor our obligation, but to honor the obligation of those who have dumped their obligation on the remaining signatory companies.

Thank you, Madam Chairman. I will be delighted to answer any questions.

[The prepared statement follows:]

Statement of R. Page Henley, Jr. Senior Vice President -- Development, Westmoreland Coal Company June 22, 1995

Before The U.S. House of Representatives Committee on Ways and Means

Mr. chairman and Committee members,

My name is R. Page Henley, Jr. and I am Senior Vice President of Development, Westmoreland Coal Company, the nations oldest independent coal company. In December of 1994 we emerged from Chapter 11 bankruptcy proceedings. Our company operates mines in the states of Virginia, Kentucky and Montana. Prior to the Chapter 11 proceeding, we also produced coal from mines in West Virginia and Kentucky which we no longer own. In fact we were the nation's 24th largest coal producer out of hundreds in 1993 producing about 11.6 million tons of coal.

Primarily because of noncompetitive mining costs, in an extremely competitive market, we had so close our West Virginia mines and sold our Kentucky Criterion mining operation in Kentucky.

We have been assigned 2, 213 retirees under the Coal Industry Retiree Health Benefit Act of 1992 (the "Coal Act.") Our annual contribution to cover these retirees' costs is approximately \$5,200,000.

We understand that there are some companies complaining about the burdens of the Coal act and that is why you are holding these hearings. The reasons I am here today is to tell the Committee that as a financially strapped coal company, fighting for our very existence, we are extremely concerned about maintaining the equities of the Act as passed by the Congress in 1992. Our pre-act obligations created a very inequitable dilemma which contributed to our financial difficulties.

Up until the passage of the Act, Westmoreland like other signatories to the wage agreement with the UMWA, was not only paying for the benefits of our own coal miner retirees and their dependents but was paying for other retirees "dumped" by companies far more capable than we to provide contractually promised benefits for their own retirees. The financial burden of assuming a share of paying for other companies' retirees benefits was a significant burden upon our company at a critical time. Those who dumped their beneficiaries on Westmoreland and other signatories of the 1988 Wage Agreement now have the audacity to now claim that since we no longer have to pay for their former retirees' benefits we have obtained a "windfall!" This is a ridiculous assertion. In truth the Act restored the equity which should have been there all along.

I would hope that you would not reburden our company in any way by the passage of such ill-conceived and unfair legislation as that currently before you in the form of H.R. 1370 or other proposals suggested to this or the 103d Congress. For our part, we feel the Coal Act is working as intended, equitably placing the burden of funding benefits upon all employers both former and current.

I'm sure there have been some improper assignments of liability, but I understand the appeals process is working and over 175 companies have been excused. This is the proper way for companies to achieve relief if there are inequities. If there is any relief to be granted because there are surplus funds, then relief should go across the board to all contributors to the Combined Benefit Fund, not just to those who were forced to own up to their responsibilities by the Coal Act.

In closing I would like to reiterate that the Coal Act restored the proper equity to the Coal industry's responsibility to care for its retirees. If legislation such as H.R. 1370 is passed this equity will be destroyed and we will revert to the former time when just a few companies bore the burden of many other companies' retirees as well as their own. We trust the Committee will see this campaign to pass H.R. 1370 for what it is — a blatant effort to pass their responsibilities to others for their economic and competitive advantage.

Thank you.

Chairman JOHNSON. Thank you for your testimony, and I apologize that the order of the panels wasn't better. It was before, but

they got switched around.

I welcome back my colleague from Ohio, Mr. Portman. We really need to get at the issue of promises made because my understanding is that only the companies that signed the 1978 agreement and following agreements committed themselves to what is called the evergreen provision and we did have someone on the record today read from the contract that they had signed which made it very clear that, as most labor contracts, the obligation was for the life of the contract.

In 1978, when you adopted a contract with an evergreen clause, you did something different; we are obliged to pay this whether these people worked for us, whether we are in business, no matter what happens. I consider that one kind of promise. I think one of the problems is that the promise wasn't the same all along the line. All of you have said that it is not true, so let's hear it.

Mr. TRUMKA. I guess I will go first. That was considered at great length, and the same argument was made to the Dole Commission appointed by Secretary of Labor Elizabeth Dole under the Bush

administration.

Chairman JOHNSON. Weren't the 1978 agreements the first

agreements to conclude the evergreen clause?

Mr. TRUMKA. Madam Chairman, the evergreen clause is not the only promise that was made. Back in 1950 miners were told this and this is what the Dole Commission found as a matter of fact, that when they retired, they would get two things, a pension and health care for life. They took reduced pensions since 1950 in order to help pay for that health care. That is what the conclusions of the Dole Commission were, as a matter of fact.

Chairman JOHNSON. But at the time that that agreement was made, there was a pool that employers paid into. When they got out of the business they paid up and left. So, on both sides it was a different agreement. When it was put in writing in 1978 and provisions were made in writing for long-term obligations, there was

also a long-term commitment of funding.

The preceding agreement—I agree with you miners had a right since that seemed to be, even though it wasn't in the contract, but companies also had a right to believe that their obligations could be fulfilled if they left by paying up on their own people and the successor company, whoever hired them. I guess I am saying that the obligation pre-1978 was in fact different from the obligation of post-1978 although I hear what you are saying about the expectation.

Mr. TRUMKA. The expectations are absolutely clear. Everybody agrees, I think even the people that say they want out of the reachback provision would agree that the expectations were clear, that miners were led to believe in contract, in word and in deed that when they retired they would get two things; a pension and health care for life.

In 1978, a new clause was instituted. Some of the people that testified here today, regardless of this act, were post 1978 signatories. Pittston, for one, has been judged to owe an evergreen obligation. That is the clause you are talking. Nonetheless—I am speak-

ing from the beneficiaries' point of view. They were promised two things, health care and pensions. They took lower pensions so that they could have health care.

Chairman JOHNSON. Thank you.

Mr. Farrand.

Mr. FARRAND. I would respond very simply that there have been at least two court decisions which affirmed that a promise of benefits was made. What they did not do is affirm a method of paying for those promises and the obligation to provide benefits was there, the obligation to pay for them went from contract to contract.

I might point out that even the BCOA companies, who did live up to those obligations, had a legal right after expiration of the 1988 agreement to say, I am sorry; we are not going to do this anymore. We did not. We found another way to do it, and we are paying for our obligations and retirees and for the orphans with moneys we previously put into the pension trust.

Chairman JOHNSON. Mr. Farrand, I found your comments on the

chart very useful.

Mr. FARRAND. Thank you.

Chairman JOHNSON. Also in our background materials there is the information that absent the provisions of the 1992 coal act, the 1988 signatory companies would have been paying essentially 100

percent of the expenses of the retiree health benefits fund.

In contrast, during fiscal year 1995 the premiums paid by the 1988 signatory operators are expected to contribute approximately 38 percent of the income of the combined fund. Premiums paid by reach-back companies will account for approximately 24 percent and a transfer from the pension fund about 32 percent and investment income from accumulated assets 6 percent. This agreement did give the operating coal companies extraordinary relief. It went from 100 percent liability down to 38 percent.

Mr. FARRAND. Madam Chairman, I beg to disagree. We did not have to provide any benefits after the 1988 agreement expired. The relief we got was not from the obligations that we owed our own retirees or their dependents. The relief we got was an implied obligation that existed from the 1988 agreement to pay for somebody

else's retirees.

If anybody had relief, it was the reach-back companies that dumped their retirees into the funds that we were subsidizing. We were in effect subsidizing our competition and we couldn't afford to do that anymore and that is why we came to Congress.

Chairman JOHNSON. And your sense of outrage at having to pay for employees that were not yours is parallel to the outrage we heard on the earlier panels, companies having to pay for employees

that were not theirs.

Mr. FARRAND. There is a fundamental difference, if I might. The obligation for a lot of those people, and there may be individual cases which are erroneous. In fact, I think the SSA has already relieved 175 companies of their obligation that they were erroneously assigned beneficiaries.

I am sure each case differs and I have some familiarity with some, but I do not pretend to be an expert. But there is a difference; that is, that those companies or most of them had either

predecessors or subsidiaries that signed an agreement that had the

promise in it, to put it in simple terms.

Chairman JOHNSON. That is where we get into muddy water. A lot of those companies did not sign agreements. There was an assumption, but later on there were agreements that were clear. Before the agreements were only based on the environment in which we were all operating.

Mr. FARRAND. Our industry has a long history of having companies go in and out of business or be traded or sold or whatever. We have a phrase in our industry called legacy costs. If you acquire something you better be damned certain what those legacy costs are.

Legacy costs by definition in our industry are retiree health care, retiree pension obligations and post mine reclamation obligations. Some of those companies had those obligations, but may not have been aware of it. They acquired those obligations either in the purchase of other companies or they had them in the contract which they signed, but did not really understand.

Chairman JOHNSON. Mr. Hancock would like to join in this.

Mr. HANCOCK. You are talking about legacy costs. In 1990, how would anybody have been able to predict the legacy costs that they are involved in now? In 1991, how would any legal advisor or financial advisor have been able to predict the legacy costs of the employee benefit plan of this company that you might be buying?

Mr. FARRAND. I am not certain I understand your question.

Mr. HANCOCK. You say when you buy a company, an obligation of the buyer is to look at the legacy costs. How could anybody prior to the passage of the coal act be able to predict the legacy costs? Mr. FARRAND. The act was designed, Congressman, to assign

beneficiaries-

Mr. HANCOCK. I understand. I am saying that if I had wanted to buy a coal company in 1990 or a company that was no longer in the coal business, but had at one time been in the coal business, how could I possibly have predicted or analyzed or determined any potential unfunded liability of the legacy costs of a pension plan and health plan on a law that did not even exist?

Mr. FARRAND. Well, there were contracts that existed that people signed and they had clauses in them that had at least an implied obligation. The fact that Congress changed the definition of that obligation they could not have anticipated, and to that extent I

agree with you.

The fact is that those companies did sign agreements. Many of them who appeared today signed agreements that had an evergreen clause in them. Certainly, the court decisions, if they had any connection with the coal industry, they knew what the court decisions were that said the promise had been made as far back as 1950 and there was an obligation there.

Mr. HANCOCK. This is for Mr. Trumka. In correspondence to the Congress you have suggested that you think relief for some small businesses may be necessary. If the coal act has resulted in economic problems for these companies, then wouldn't a comprehensive review of the coal act be reasonable, not just a quick fix for a few businesses?

Mr. TRUMKA. First of all, I think we have to give the act a chance to work and let things start to settle down. It has only been there 18 months. You have just seen and heard testimony today how it is working.

I believe that if we let it work for awhile and we find out that there are companies that are truly going to be jeopardized, and not the claim of it, but come in and talk about it, that they are going to be jeopardized, if that is the case, we would be interested in looking at a way to help them solve that problem, because it doesn't do us any good to say to a company your out of business. We would be better off saying if you cannot afford to do a full

loaf, then you should perhaps give a part of a loaf. We would all be better off. I think we need to let the act work to see if it can sift out. You talked about legal bills today. There is a lot of them, all because they challenged the constitutionality of this act, all of which they have lost. There have been a number of challenges about assignments, some successful, some not, but the act is starting to work.

What we cannot do without jeopardizing the health care that these people were promised, and they were promised this and they believed the promise, and we gave up pensions in order to keep the health care. We gave, \$210 million of our pension money went into this very fund. That is how the orphans, the people without anybody out there, their last company is gone, that is how they are getting health care, from our pension money. So, one more time we are giving it.

Before you say take the surplus out of this thing, let it act, and we made a commitment that if there are companies jeopardized by this—not a company that is making millions of dollars and this would be nice to get rid of so that he or another company has to pay for their pensioners and that is what they are asking us to do, but a company that is genuinely jeopardized, we would be in favor

of helping them.

Mr. HANCOCK. I understand you are—in fact, you said several times that the pensioners were promised health care for life and also a pension for life. As you know, we have had some problems there and that is why we had the Pension Benefit Guarantee Corp., because some were improperly funded.

Mr. TRUMKA. That is correct.

Mr. HANCOCK. It would appear to me that when you promise somebody health care for life that you ought to fund it at that time instead of future funding. We also, in 1964-65 when we passed Medicare, promised basically certain minimum standards of health care for life. They were not told that they were going to have to start paying premiums for it later on.

My question is, we are in a different time now and we want to save the system. In fact, even Medicaid now, they are talking about controling costs, that you need to have some type of beneficiary

contribution.

The President's plan even said that the only way we are going to get it under control is if the beneficiary has some type of financial investment in it. Have you considered anything like that?

Mr. TRUMKA. Sure. Let me tell you something you may not know. We are pretty proud of this. This group of beneficiaries, we have a cost-containment program. We were the first ones to do HMOs in the fifties with the funds. Our costs are lower per beneficiary

than Medicare are. So, we are doing our part.

When you talked about why we do not fund health care plans, Congress has made it impossible for a company to fund them because if you go beyond this year's current expenses you cannot deduct it. I tried to get them to do that and I negotiated with them three or four times and I said we got to start funding them. They said are you crazy? I cannot deduct it. That makes good business sense, and I guess they convinced me of that.

The other thing, in 1978 our pension funds were very underfunded. In fact, there was a chance at that time that they were going to go belly up. And these companies, the companies that were signatory, actually accelerated the pension funds from 1978 until

roughly, 1990, 1992, and we fully funded those plans.

Guess what, a lot of those companies that sat here today and promised their pensioners pensions did not pay a cent to fund those pensions. These guys did. They stayed with it, paid an accelerated amount to fund the pensions that the previous companies had promised but not paid for.

Mr. HANCOCK. One of the things that we are looking at in the tax bill is a modified form of funding of medical care for individuals, which is called the medisave account. I hope we are able to

get that done.

Mr. TRUMKA. I hope we can work with you on that.

Mr. FARRAND. May I add an addendum? I am sure he is unaccustomed to having me agree with him, but I am going to agree with him in two respects.

One, I would associate ourselves with his remark that we are willing to work with the Committee to address some ways in which small companies that are financially unable to meet their premium obligations can be dealt with, as long as there is the basic principle that wherever they are capable, the former employers ought to be responsible for their own retirees.

Having said that, I want to address one thing in H.R. 1370 that you reminded me of just now. That bill in simple terms, as I understand it, would relieve the reach-back companies of premium obligations whenever there is a cash surplus in the benefit fund exceeding 10 percent of the annual claims against the fund. That

is a real problem.

There is a backlog of payment streams, of payment requirements and claims, maybe 60 to 90 days. If you cut off the cash or cut off a large portion of the premiums due starting in January because there happened to be a 10 percent cash overhang from the previous year, that fund will be certainly in cash flow difficulties if not in deficit in very short order.

The analogy I would think of is if you have a Social Security trust fund now and it is over funded, if you excuse the employers and employees of the country of contributions to the Social Security trust fund because there happened to be a temporary cash surplus in the account, I think you would have to agree that it would go belly up in a hurry and that is the same thing that is in your bill. That is why we are concerned that once you open that door, once

you reduce the payment stream the fund may slip into a deficit

quickly.

There is a court case out there that says the premium levy is too high. That needs to be addressed. There may be assignments out there that are erroneous, but that is being addressed within the mechanism of the act and I do not believe it needs to be corrected by statute.

Mr. HANCOCK. Thank you.

Chairman JOHNSON. Mr. Portman.

Mr. PORTMAN. I thank the Chair and appreciate the testimony. I did get to hear from Mr. Trumka before I left. I was intrigued by your comments on small business relief. I was happy to hear

your response to earlier questions on that by, Mr. Hancock.

Just a brief comment. We were talking earlier about the constitutional challenges. You indicated that, yes, many of these companies, smaller and midsized in particular, have expended what would seem to be an enormous amount for legal and accounting fees and that their challenges had been unsuccessful. We have the recent Unity Real Estate case.

I understand that goes more to a takings issue than to a due process claim. That case would only, as I read the summary, confirm what we have learned today, which is that there are companies who are in a situation where application of the 1992 act is patently unfair. Are you familiar with that case?

Mr. TRUMKA. Not with that specific case, no.

Mr. Portman. I think it was June of this year or maybe late May, but it was, in essence, saying that this was more an appropriation than a public program concerned with employee benefits, the 1992 Act. I think there is some evidence that, to me, is consistent with what we have heard today that there are certain companies that find themselves in a very unfair situation.

I earlier commented on the super reach-back companies, and I do think they are in an unusual situation. Mr. Farrand talked about the fact that every company situation is different. I am sure it is. And every commitment is different whether in writing or otherwise, but I think the 1978 timeline is a difference with a distinction

or a distinction with a difference, or both.

I think we have to be careful about just saying companies that cannot afford to pay or small companies might be deemed to get some relief, which I agree with, but we need to look at the fairness and do this in a principled way. I see super reach-back companies as being in a different situation. Do you have any comment on that?

Mr. TRUMKA. I do indeed. First of all, what I would say is there is a number of—in the coal industry there are a number of situations where we have current companies that are paying for the past sins of some of the companies that were in front of us today, the Abandoned Mine Reclamation Act, for instance.

Whenever a company went out of business before they just left the mine there; we have to reclaim that. Whenever we had companies that had their employees incur black lung and we decided to compensate for that, those people were gone and we had these companies that are ultimately paying through a black lung tax. Some of the unfairness, I guess, is on both sides, and let me tell you what we face going into the negotiations. We had companies that were still in business that were really trying to be honorable and live up to the promises that they made and they were paying \$3 for somebody else's pensioners for \$1 of their own pensioners.

They said to us, and they weren't posturing; they said, we cannot do it anymore. We cannot continue to pay because things keep shrinking smaller and smaller. And they tried to address that specifically in 1978, and with the Evergreen clause. It was called the Last Man's Club. They wanted everybody to know that there wouldn't be a last man. But we still kept getting more of a last man around.

The 1950 figure came about with negotiations with the White House, and the 1950 figure, whenever they decided that they did not want an industry tax actually came from the White House negotiators, the Bush administration negotiators. They realized we had to have a certain amount of money and if you weren't going to have a tax across the industry like you did with the abandoned mine lands or the black lung tax, you had to have a funding stream.

He pays for every single one of his pensioners plus he pays a big share for the orphans in addition to his own. He has never gotten a break on that. The only way that we could have got the funding stream necessary was for them to reach back, and that was, as I recall, a proposal from the White House negotiators.

Mr. Portman. Even the Bush White House wasn't perfect, right? I understand that context. I think we could talk all day about the history of that, how it evolved, whether it was a reasonable proposal or not or whether it was put forth as a reasonable proposal in terms of super reach-back or whether anybody thought that it would ever be enacted.

What I come back to is I think it is worth backing up and taking a look comprehensively at the 1992 act and how it applies to various companies. I do see a distinction between those who were part of the Evergreen process in 1978 and those who were not.

You look at individual circumstances and it is not being applied fairly. At the same time, I will agree that based on the testimony I heard earlier today, the degree to which there is going to be a surplus has yet to be seen. I think that is an honest evaluation. I do not think anybody can pinpoint what that number will be or that there will be a significant surplus. I hope I am wrong and I think it would depend on external factors such as the new capitation plan.

Mr. TRUMKA. I hope you are wrong, too.

Mr. PORTMAN. I do think we need to look at the whole thing. I am encouraged by your statement on small business and would encourage you to work with us to look at the whole situation and try to come up with something that is fair, particularly as it relates to those companies who were not in the coal business at the crucial time in 1978, weren't part of that agreement, were not part of the Evergreen clause.

Although I have many questions, Madam Chair, my red light is on and I yield back.

Chairman JOHNSON. There is one other area that I think we need to pursue. Do the participating companies or the union—does anyone exercise any oversight over this fund and the medical

expenditures?

Mr. TRUMKA. Yes. There is a number of people that exercise oversight over it. The companies do because they want to keep costs as low as they can. We do because we want to keep medical benefits. Under this fund we are on a locked formula, so costs cannot go out of sight without us losing the benefits. In addition, you have Social Security and DOL.

Chairman JOHNSON. Perhaps one of you could explain why when prescription drugs are such a large part of your expenses you have only this year adopted a protocol to help manage those benefits. It

seems to me that would have been done 1, 2 or 3 years ago.

Mr. TRUMKA. It was done several years ago. In the sixties we had mail-order drugs that were mailed out from the funds. Those programs ultimately went by the wayside. There are a lot of prescriptions because this population is so old they are on maintenance drugs.

We have, as far back as 1978, begun doing cost-containment with those health care costs. If you look at them, this group of beneficiaries, despite their age being older than the Medicare popu-

lation, does better than Medicare does.

Chairman JOHNSON. Why, if that is the case, and 90 percent are Medicare folks and you are getting a capitated Medicare payment and they cost less than Medicare, why are you having trouble paying for this?

Mr. TRUMKA. Here is why. Because Medicare CPI does not use

utilization.

Chairman JOHNSON. That is the complaint—

Mr. TRUMKA. It gives you a cost increase for cost, but this group because of their age, and the actuaries talked about this today, I believe; this group has a much greater utilization because of their age. Because of utilization, even though they do better at the cost, the utilization is higher. That is why the medical CPI, as it is predicated being paid to them, will not cover this group, long term

costs even if, as we are currently doing, we do better.

Chairman JOHNSON. We need a better explanation of the figures we have showing. What percentage of outlays are covered by Medicare reimbursements, because it is 50 percent one year and 47 percent another year. If you have 90 percent Medicare recipients, you ought to be able to do better than that. Even if Medicare is under reimbursing, it is not under reimbursing 50 percent. It is just—I do not know what the explanation is. I just want to make sure that it is clear that we need better information about the governance of the medical expenses and of this fund as we move forward.

I also want to get back to Mr. Farrand's comment that you want to stay with the principle of people paying for their own employees. You know, in 1988, some companies chose to satisfy by a withdrawal liability provision that was supposed to provide them with freedom in a sense by making a substantial settlement when they left the fund.

Those companies, in a sense, are now paying a second time. I just point that out because I find very disturbing the inequities that this law has imposed on many employers, and I find it disturbing to see employers who are only distantly related to coal production contributing to richer benefits for others than they are

contributing for their own employees.

I see this from the point of view of a policymaker who watches these issues across our society, and just as in the pension area where companies went bankrupt, the government picks up those costs through the Pension Benefit Guarantee Fund, but we do not pick up whatever was negotiated. We pick up a minimum cost. The fact that from the 1988 agreement to the 1992 law there wasn't any renegotiation of benefits, which has gone across every industry throughout our society, there wasn't any change in the extraordinary definition of dependents or perhaps any look at the benefits. That is concerning to me.

Mr. TRUMKA. I am concerned about a lot of things. First, your question about the reimbursement rate not paying for Medicare

drug costs. If you give it to me, I will be glad to answer it.

Second, if you show me the companies that have paid for it and you think this will be a double payment because they withdrew from the funds and paid for the amount of their health care, I will

be happy to answer that as well.

And third, I hope you are not suggesting by your statements that these people do not deserve the benefits they receive. They get pensions of under \$200 a month. They gave up pensions to get this level of benefits and then \$210 million was taken out of their pension funds to pay for the orphans. They could have received increased pensions. Now, they are too old to go back and strike the deal again.

This deal was they would get this level of benefits and this level of pension and not one of them has said they want anything better than the deal. They just want the deal. Those benefits have been examined by the Dole Commission and found to be fair when you

combine them with the pension that they get.

My dad and mother happen to be recipients of those benefits, that pension and that health care, and their employer, LTV, dumped them after my dad worked 44 years for that company, dumped them and said, too bad; you are not going to get health care. It nearly killed my dad. And like my dad, there are thousands of them out there.

I hope you are not suggesting by this that the benefits they get

are underserving, because they earned every one of them.

Chairman JOHNSON. We are certainly conscious of the importance of health benefits to retirees and that this industry has managed the health benefits differently than other industries because of the health exposure in this industry, which is different than in most industries.

I just think it is important to recognize that in this particular area under this particular law the issue of fairness is really difficult, and we have reached a point where I think we do have to look at what is happening to some of those that were affected in a way that, frankly, no other law has ever affected people in our society.

Under no other law has government come back 20 years later and said while it used to be this way, now it is that way. The only other parallel I can think of is Superfund and holding people retroactively liable for things that were perfectly legal and actions that they took that they thought were complete. We are having a lot of trouble with that.

I think this all deserves a careful review. We certainly are sensitive to the needs of the people involved, but we are going to be looking and seeing what we can find, how we can alleviate some of the gross injustices that this law has imposed on some companies. That is where I am starting. I am not starting with any conclusions, but I think the questions are significant.

Mr. Farrand.

Mr. FARRAND. Thank you. As the Committee proceeds in this manner, I would ask you to keep the concept of fairness in context. It is a relative term. I go back to the dilemma that I outlined ear-

lier. You had some not very happy choices.

Either you could let this fund go bankrupt and in effect deny the benefits to the people who were promised them and that will be extremely unfair. You could impose the costs of this fund across the entire industry, including companies that never had any connection with the national UMWA agreement, and that was perceived to be unfair.

You could impose these costs on a shared basis across all the signatories past and present and that was deemed to be difficult to do because it did not determine how you would precisely apportion the share of costs. Or you could go back to the principle we mentioned earlier, which is, the companies that made the promise should pay. I am not suggesting in each case that is fair in an absolute context, but I would ask you to keep in mind the relative context.

Mr. Henley. I wanted to add that the fairness, as Mr. Farrand said, cuts both ways, and there is a fairness issue in companies like ours being required to pay for other people's retirees, and what I have tried to reiterate in my remarks is that this act restores a good old American custom of taking care of your own, and these men who worked and made these companies, in many ways, what they are today are people that are owed something this act has restored that equity and that balance.

While you have heard many cases that it may be unfair for being brought in, to cast this act out, then, will recreate what was, in fact, an ever-increasing unfair burden on other companies. So, it is a very difficult balancing act that you are about. I fully agree.

Chairman JOHNSON. I thank you for your testimony and for your patience throughout the day. I thank my two colleagues who hung in here with me for most of the day.

The hearing is adjourned.

[Whereupon, at 4:25 p.m., the hearing was adjourned.]

[Submissions for the record follow:]

STATEMENT OF THE ASSOCIATION OF BITUMINOUS CONTRACTORS. INC.

before the

SUBCOMMITTEE ON OVERSIGHT OF THE COMMITTEE ON WAYS AND MEANS

on the

COAL INDUSTRY RETIREE HEALTH BENEFIT ACT OF 1992

The Association of Bituminous Contractors, Inc. ("ABC") submits the following statement to the Subcommittee on Oversight of the Committee on Ways and Means, to be included as part of the printed record of the June 22, 1995, Oversight Hearing on the Coal Industry Retiree Health Benefit Act of 1992 ("Coal Act").

ABC is an association of approximately 100 construction companies which perform construction work for coal company customers. ABC members are small and medium-sized independent construction contractors. ABC members are not coal mining companies, and do not mine coal. Unlike coal companies which perform work under the National Bituminous Coal Wage Agreement, ABC members are covered under a separate collective bargaining agreement with the United Mine Workers of America known as the National Coal Mine Construction Agreement. ABC and the UMWA have negotiated a series of such agreements beginning in 1968. Under the National Coal Mine Construction Agreement, retired UMWA construction workers are provided health and other benefits from a separate multiemployer plan known as the 1978 Retired Construction Workers Benefit Trust. These benefits are funded by contributions from employers signatory to the Construction Agreement.

Congress enacted the Coal Act believing that certain coal mining companies had "dumped" their retirees into the old UMWA Benefit Funds (known as the 1950 and 1974 Benefit Funds) and that the only way to make the Benefit Funds solvent was to "reach back" to pre-1988 Coal Wage Agreement signatories for contributions. In formulating the "reachback" definitions to accomplish this goal, Congress inadvertently used language that has been interpreted to bring construction contractors, members of ABC and other employers signatory to the National Coal Mine Construction Agreement, within the scope of the Coal Act. No one in Congress or elsewhere ever expressed the belief that construction contractors were intended to be targets of the Coal Act. Nonetheless, since October 1993, the federal agency charged with assigning UMWA retirees to their former employers (previously the Secretary of Health and Human Services and now the Commissioner of Social Security) has been pursuing ABC members for contributions under the Act.

ABC submits that the Coal Act should be amended to clarify that assignments of beneficiaries cannot be made to employers on the basis that they were signatory to the National Coal Mine Construction Agreement. This can be accomplished by amending the definition of "wage agreement" under the Act to specifically exclude the National Coal Mine Construction Agreement in the same manner that the definition of "wage agreement" specifically includes the National Bituminous Coal Wage Agreement. This amendment is required for the following reasons:

ABC members and their employees are not part of the coal industry to which the "reachback" provisions of the Coal Act were aimed. Rather, ABC members are part of the construction industry. They work under an agreement with the United Mine Workers of America only when they perform construction work for union coal commanies.

ABC and the UMWA have successfully negotiated collective bargaining agreements with health and pension plans to take care of retired UMWA construction workers. The most recent agreement went into effect on February 11, 1995, and requires signatory contractors to make contributions to the 1978 Retired Construction

Workers Benefit Trust to fund health benefits for construction worker retirees.

Although a handful of beneficiaries of what was formerly the UMWA 1950 Benefit Plan at one time had some measure of employment with ABC members, the inclusion of these individuals in the 1950 Fund was the result of the UMWA's desire to provide them benefits from the 1950 Fund. With the concurrence of both the UMWA and the BCOA, whose trustees controlled the 1950 Fund, these individuals were provided benefits from the 1950 Fund without any expectation of contributions from ABC members. Therefore, whatever funding difficulties the 1950 Fund ultimately experienced can in no way be attributed to ABC member companies. The concept of "reachback" simply does not apply to construction contractors who did not have any obligation to make contributions in the first place. It is not only unreasonable but totally irrational and arbitrary to hold construction contractors liable for a problem they did not create.

The assignment of Combined Fund beneficiaries to construction contractors unfairly burdens ABC members who have fully provided for the health benefits of their UMWA construction worker retirees, and who have lived up to all their obligations under the National Coal Mine Construction Agreement. Even though the number of Combined Fund beneficiaries assigned to construction companies is small in the overall scheme of the Act (less than 100), it creates an unfair, unreasonable and intolerable burden on those contractors who are required to subsidize another industry's problem.

The inequities being inflicted on construction contractors can and should be eliminated by amending the Coal Act to exclude the National Coal Mine Construction Agreement from the definition of "wage agreement" as that term is used under the Coal Act. Because the number of beneficiaries assigned to construction contractors is os small, such amendment will not significantly affect the current or future financial status of the Combined Fund.

Respectfully submitted,

ASSOCIATION OF BITUMINOUS CONTRACTORS, INC.

Record Statement by SMALL NON-COAL PRODUCING COMPANIES AGAINST THE REACHBACK TAX Submitted to the SUBCOMMITTEE ON OVERSIGHT COMMITTEE ON WAYS AND MEANS

Hearing on Coal Industry Retiree Health Benefit Act of 1992 June 22, 1995

This written statement for the printed record of the public hearing on the Coal Industry Retiree Health Benefit Act of 1992 is being submitted on behalf of small, non-coal producing companies, whose existence, and the lives of whose owners and employees, have been drastically affected by the reachback provisions of the Act. The statement is submitted by representatives who have obtained the consent of over 75 companies to express the views of small, non-coal producers under the title, "Small Non-Coal Producing Companies Against the Reachback Tax."

"Small Non-Coal Producing Companies Against the Reachback Tax" is not an officially organized or incorporated entity. It is the name given to a class of companies (a) who are small, most having gross annual revenues less than \$25 million; (b) who are reachback and super reachback companies, none having signed the 1988 UMWA-BCOA Wage Agreement or a subsequent agreement; (c) who ceased coal mining operations before February 1, 1988; (d) who fulfilled all obligations to the last UMWA-BCOA Wage Agreement to which they were signatory; and (e) who, by virtue of their small size, are drastically impacted by the financial burden imposed upon them by the reachback provisions of the Act.

Many of the companies who share the views expressed herein could not afford to hire, for one day, the legal staff and lobbyists on which the large 1988 signatory and reachback companies have expended millions in attempting to shift the cost of UMWA retiree health benefits, which prior to the Act were governed solely by private contract. The position of these small companies needs to be expressed and, more importantly, needs to be heard.

These small companies had no opportunity to participate in any of the discussions or negotiations that led to passage of the Act. Many did not even know about the Act until they received notice that they were expected to pay premiums for beneficiaries of benefit plans into which they had made all required contributions, and which were solvent when they left the coal business.

These small companies cannot be accused of "dumping" retirees. Most were small operators who were forced out of coal mining by large operators, whose capital allowed them to develop large mines with lower production costs, and whose coal pricing tactics left small operators little choice but to cease operations. The reduction in small and medium-sized mines is evident from Table VI. Trends and Number of Mines by Size (Mine Production Range) on page 74 of the Committee Print, "Development and Implementation of the Coal Industry Retiree Health Benefit Act of 1992" dated June 22, 1995 (hereinafter "Committee Print").

These companies, though small in size, represent the largest group in number of companies impacted by the Act. According to the Committee Print, as of March 31, 1995, 257 reachback companies are responsible for premiums for assigned beneficiaries. Of this group, our information indicates that only 103 are actually paying premiums, of which more than half are believed to be small, non-producing companies. The remaining 154 reachback companies are paying nothing, largely because they cannot afford to. Some of these companies have filed bankruptcy. Some are engaged in litigation. All run the risk of crippling fines and penalties under the Act, mainly because they have no other choice.

These small companies, which have now been assessed unexpected premiums under the Act, did not run from their mine operation obligations. They survived. They met reclamation and environmental obligations, preventing these from being dumped on state agencies or the Abandoned Mine Lands Fund. They met Workers' Compensation and Federal Black Lung obligations. Some even moved into new industries, creating jobs, paying wages and taxes. They should be applauded, but instead, Congress rewarded them with the reachback provisions of the Act, imposing totally unexpected and unforeseeable obligations for retiree health care which, by private contract and court decision, had never before been their obligation.

These small, non-coal producing companies now come forward as the group which most closely embodies Congressman Pickle's warning,

"Let me also warn my colleagues, you have not heard the last of this issue. We have no idea who all these companies are. There will now be a rush to track them down and tell them that they will have to pay millions of dollars a year into this health plan over which they have no control. Some will be forced into bankruptcy, others will be forced to lay off workers. And they will blame you and me, and they will be right. So plan today what you will tell them, it won't be easy." Remarks of Congressman J. J. Pickle, Before the House Ways and Means Commitee, October 5, 1992.

These small companies, which no longer produce coal and which did not sign the 1988 Agreement, now seek a fair response. We played by the rules. We met our responsibilities. Why should we pay the penalty while other companies reap substantial benefit from the Act? As the Committee staff has reported:

"Absent the provisions of the 1992 Coal Act, the 1988 signatory companies would have been paying essentially 100% of the expenses of the UMWA Retiree Health Benefit Funds. In contrast, during fiscal year 1995, the premiums paid by the 1988 signatory operators are expected to contribute approximately 38% of the income of the Combined Fund. Premiums paid by the reachback companies will account for approximately 24%, the transfer from the UMWA 1950 Pension Fund 32%, and investment income on the accumulated assets of the Fund 65%."

Committee Print at page 34.

The small, non-coal producing reachback companies appeal to the members of this Subcommittee for legislation which will address the devastating impact of the Act upon them. H.R. 1370 is not such legislation, and Small Non-Coal Producing Companies Against the Reachback Tax oppose it. H.R. 1370 does not solve any problems for small reachback companies. As indicated previously, many are not paying premiums, H.R. 1370 does not relieve any of these companies from liability for premiums, fines or penalties - they remain subject to collection efforts for premiums due since October 1, 1993, and further subject to litigation costs and expenses for contesting premiums.

More importantly, H.R. 1370 will use up the surplus which has developed in the Combined Fund, eliminating one possible source of funding relief for small companies. The beneficiaries of H.R. 1370 are the large reachback companies, many of whom are still producing coal and would be responsible for payments for retiree health benefits under the Evergreen litigation. H.R. 1370 merely adds injustice upon injustice by relieving producing companies who, absent the Act, would otherwise be liable for retiree health care under the Evergreen clause.

Small Non-Coal Producing Companies Against the Reachback Tax urge that H.R. 1370 be withdrawn and be replaced by legislation which, at a minimum, gives meaningful relief to small, non-coal producing reachback companies drastically impacted by the Act. In oral testimony before the Subcommittee, representatives of the BCOA and the UMWA expressed support for such legislation. Moreover, representatives of our group have met with Senator Rockefeller, the principal sponsor of the Act, and he has expressed a willingness to entertain amendments to the Act which relieve small companies of unnecessary burdens so long as relief does not jeopardize retiree benefits.

Relief for small companies is not an expensive proposition. Small Non-Coal Producing Companies Against the Reachback Tax estimate that of the \$47,900,000 in annual premiums now being paid by all reachback companies, only \$5 million is being paid by small, non-coal producing reachback companies. With a surplus in the Fund in excess of \$100 million, relief of \$5 million annually is a relatively small amount, but it will go a long way towards relieving the desperate situation the Act has created for many small companies.

We urge the members of the Subcommittee to consider legislative alternatives to H.R. 1370, and to meet with other interested Congressmen on both sides of the aisle to discuss alternatives which will not again leave small, non-coal producing companies and their employees stranded behind all other interest groups.

We appreciate the opportunity to present this written statement and would welcome the opportunity to meet with and respond to inquiry from any member or staff person concerning the comments herein or possible alternative legislation.

Small Non-Coal Producing Companies Against the Reachback Tax

C. L. Christian, III Imperial Colliery Company Richard Weinzierl
Barnes & Tucker Company

James Bailes, Esq.
West Virginia Reachback Coalition, Inc.

STATEMENT SUBMITTED BY RICHARD D. RIVERS VICE PRESIDENT BERWIND CORPORATION OF PHILADELPHIA BEFORE OVERSIGHT SUBCOMMITTEE HOUSE WAYS & MEANS COMMITTEE June 22, 1995

Madam Chairwoman, I am Richard D. Rivers, Vice President of the Berwind Corporation of Philadelphia, Pennsylvania.

The purpose of my testimony is to endorse subcommittee action on H.R. 1370 as a first step in rectifying a grievous wrong that was inflicted upon certain "Super Reachback" companies during consideration of the Coal Industry Retiree Health Benefit Act of 1992.

I would like to briefly outline why I believe these companies in general, and Berwind in particular, should be totally exempt from the Coal Act:

A. History and Purpose of the Coal Act.

- The purpose of the Coal Act was to work a "bail out" of two health benefit plans for UMWA retirees. The two plans were created in 1974 by the UMWA and the coal companies that were BCOA members at that time.
- The Coal Act in effect merged the two benefit plans created in 1974 into a new Combined Benefit Fund and then required not just the signatories to the 1974 and later contracts with the UMWA, but any company which had signed a contract since 1950 to make contributions to the Combined Fund.
- Because the 1974 plans were perceived to be in dire and immediate financial distress, portions of the Coal Act were hastily drafted and adopted without a hearing and with scarcely any discussion.
- 4. As a result, the Coal Act imposed, almost inadvertently, substantial liabilities on "super reachback" companies such as Berwind -- i.e., companies which ended their relationship with the UMWA and the BCOA before the 1974 benefit plans were even created.

B. Including the "Super Reachbacks" was Almost Unintentional.

The Coal Act's "super reachback" to companies that had gone out of the coal mining business prior to the 1974 NBCWA was all but unintentional.

- The Coal Commission's recommendation was that, at most, only 1978 and later signatories should be held responsible for the solvency of the plans established in 1974.
- No one seems to know why, or at who's behest, the "super reachbacks" were included in the Coal Act. They were stuck in just before the Act was passed and without any sort of notice or hearing.

C. The Plight of the "Super Reachbacks"

 The plight of Berwind Corporation of Philadelphia typifies the Coal Act's egregiously unfair applicability to the pre-1974 "super reachback" companies.

- a. Berwind ceased mining coal and employed its last UMWA miner in 1962 -- 30 years before the Coal Act was passed. At that time, Berwind was signatory to the 1950 NBCWA which required Berwind to make a defined contribution of 30 cents per ton of coal produced to the UMWA Welfare and Retirement Fund of 1950, but only during the life of that Agreement. That Fund's Trustees had sole power to decide what benefits would be paid and to whom. Berwind fully satisfied its obligations to the 1950 Fund by contributing over \$8 million to it between 1950 and 1962, a period during which Berwind had net operating losses from its coal operations of almost \$10 million. The 1950 Fund was solvent at the time Berwind ceased participating in it. It was also solvent in 1974 when its assets were delivered over to the newly created 1950 Pension Plan.
- b. Beginning in 1974 -- 12 years after Berwind ceased mining coal, ceased employing UMWA-represented miners, and ceased participating in, or benefiting from, UMWA/BCOA contract negotiations -- the BCOA operators and UMWA voluntarily agreed to significant changes in the provision of health benefits to UMWA retirees. The 1950 Fund, a "defined contribution" plan, was eliminated, and it was replaced with two "definedbenefit" plans. Thereafter, changes were intentionally made in the funding mechanism for the benefit plans created in 1974 to reduce premiums paid by the large, more labor-efficient and highly profitable operators who were, and still are, in control of the BCOA. Changes were also made in 1974 to the plans' benefits and beneficiaries which predictably increased the newly created plans' operating costs. As a result of those changes, (and notoriously lax claims administration by the Trustees), and to no one's surprise, the plans created in 1974 became financially weak. The UMWA and the BCOA convinced Senator Rockefeller that the Coal Act was the solution to that problem.
- 2. The extreme retroactive "super reachback" liabilities created by the Coal Act are substantial. Berwind must pay over \$2 million per year to the Combined Benefit Fund. Berwind's total premiums are expected to reach \$25 million or more by the time all the Combined Benefit Fund's beneficiaries die. A significant portion of Berwind's \$25 million premiums will be attributable to persons who never worked for Berwind at all and, in at least one instance, to a miner who worked for Berwind in 1949 only long enough to earn a grand total of \$7.75 in pay.
- 3. Moreover, all of the funding and benefits changes made to the benefit plans in 1974 and thereafter were, of course, the result of trade-offs inherent in the collective bargaining process. The trade-offs were presumptively beneficial for, and advantageous to, the members of the BCOA at the time, but they were of no benefit to strangers to the 1974 and later UMWA contracts, such as Berwind and the other "super reachbacks".

D. The Combined Benefit Fund Doesn't Need the "Super Reachbacks".

All the "super reachback" companies together now contribute an
estimated 2.9 percent of the Fund's premiums. That amount could
either be paid from the Combined Benefit Fund's ever-growing
surplus or it could easily and automatically be picked up by the

remaining contributors to the Combined Benefit Fund \cdots i.e., the BCOA members who should have made those payments in the first place.

2. By and large, the present BCOA members are financially well able to pay for the benefits they created. More than 80% of the tons produced by BCOA companies are produced by two very large, highly profitable, foreign-controlled coal operators. They are the companies reaping the benefit from the Coal Act. They have bragged that the Coal Act is saving them millions of dollars per month because other companies such as the "super reachbacks" are being forced to pick up their obligations. THAT IS JUST NOT RIGHT!

E. "Super Reachbacks" Should be Totally Exempt.

In conclusion, let me state that the only fair and equitable solution to this situation is to grant relief to all companies which have been required to make payments for which they should not be obligated, as is called for in H.R. 1370. In the case of "Super Reachback" companies, that requires a total exemption from the Coal Act.

Richard D. Rivers Vice President Berwind Corporation

STATEMENT OF CLEVELAND-CLIFFS INC

to the SUBCOMMITTEE ON OVERSIGHT COMMITTEE ON WAYS AND MEANS

HEARING ON COAL INDUSTRY RETIREE HEALTH BENEFIT ACT OF 1992 June 22, 1995

This written statement for the printed record of the public hearing on the subject Act is being submitted on behalf of Cleveland-Cliffs Inc and its consolidated subsidiaries ("Cleveland-Cliffs") by M. Thomas Moore, who is Chairman and Chief Executive Officer of the parent company.

Cleveland-Cliffs is an Ohio-based natural resource Company that manages five iron ore mines and pellet plants located in Michigan and Minnesota with 4,900 employees and an annual production capacity of 34 million tons. It does not manage or have an ownership interest in any coal mine or coal-related operation.

The Act affects Cleveland-Cliffs, solely as a so-called "reachback" company, and as such we are paying assessments of approximately \$1 million per year. Our exposure is brought about by prior activities and transactions of a company which was acquired by Cleveland-Cliffs in 1986 for its iron ore businesses. It is our view that all health benefit obligations of this acquired subsidiary to coal retirees and their beneficiaries have previously been fulfilled.

Our assessments are flowing into the so-called "Combined Fund" which is used to pay coal industry retiree health benefits. The benefits and their original contemplated funding were provided by multi-employer collective bargaining between the United Mine Workers (UMW) and Bituminous Coal Operators Association (BCOA) member companies. However, substantially-reduced employer contributions commenced with the 1988 agreement, as did the financial problems that led to the Act's reachback provision. We contend that the reachback assessments are essentially an indirect subsidy to present member companies of the BCOA, which should be held solely responsible for the health benefits of BCOA beneficiaries.

Not only do we question federal mandates to solve financial problems arising from private contracts, but we believe that forcing prior signatory operators no longer in the coal business to subsidize the cost of benefits inadequately funded by signatories to <u>subsequent</u> coal wage agreements sets a bad legislative precedent and is grossly unfair to reachback companies.

While in prior years we have expressed in considerable detail our rationale for strongly opposing the reachback provision's enactment, we are not now seeking its repeal. We are merely asking for conditional relief because of the growing surplus status of the Combined Fund, and we are prepared to resume payments in the event the Fund resources are not sufficient in the future to assure payment of approved health benefits to beneficiaries.

H.R. 1370 is the answer regardless of differing points of view about the original requirements of the Act, the present surplus condition of the Combined Fund, or the adequacy of the Combined Fund to meet future health benefits. This is especially true in light of the nationwide trend toward declining health benefit costs. H.R. 1370 merely suspends the reachback assessments on the condition that an adequate Combined Fund surplus continues to exist; and it requires the resumption of reachback assessments if the Combined Fund surplus falls below a reasonable "safety cushion" amount.

The Combined Fund's surplus is now approaching \$150 million. With the safety cushion feature in place to automatically resume reachback contributions if additional funds are needed in the future to satisfy health benefit claims, there is no sound reason to oppose H.R. 1370.

It is perplexing, however, that BCOA member companies and others have found a way to attack the bill based on a controversial projection of future costs. An actuarial report has recently been produced which projects a Combined Fund

deficit in 2003 as its base case estimate. This estimate and its health care trend rate assumptions are vastly in conflict with other studies that project a huge, constantly growing surplus; and serious questions have been raised about its assumptions by a well-recognized actuarial organization.

Suffice it to say that this recent report is too dependent on questionable assumptions concerning estimated cost trends to justify denial of equitable relief to reachback companies. In any event, should there be valid doubt about the surplus condition of the Combined Fund in years to come, the safety cushion feature of H.R. 1370 provides a safeguard that ensures appropriate restoration of cash resources.

Approval of H.R. 1370 is urgently requested.

FLORENCE MINING COMPANY

July 5, 1995

Phillip D. Moseley, Chief of Staff Committee on Ways and Means U. S. House of Representatives 1102 Longworth House Office Building Washington, DC 20515

Date of Hearing: June 22, 1995

The Florence Mining Company is a 1988 last signatory operator as defined in the Coal Industry Retiree Health Benefit Act of 1992, and as such maintains an individual employer plan for its pensioners. Additionally, Florence is liable for payment of per beneficiary premiums for any pensioner assigned to it in the 1992 Benefit Plan. We recently received notice from the UMWA 1992 Benefit Plan that the Trustees of the Plan were preparing to implement the security provisions of the Act. Based upon the annual per beneficiary cost set by the Trustees for 1995, this action will require us to post security of approximately \$1.5 million. It must be noted that the 1995 annual cost of \$3,077 set by the Trustees represents a 31% increase over the previous year's cost.

Section 9712(C) of the Coal Industry Retiree Health Benefit Act of 1992 mandates the development of managed care and cost containment rules by the UMWA 1992 Benefit Plan, which may then be utilized by 1988 last signatory employers to assist in controlling costs in their individual employer pensioner plans. To date, no such managed care and cost containment rules have been forthcoming from the 1992 Benefit Plan.

The Bituminous Coal Operators Association and the United Mine Workers of America have reached agreement on certain cost control measures for the BCOA company plans mandated by the Act. These controls are not available to 1988 last signatory operators. However, the implementation of the BCOA/UMWA cost controls serves to verify the need for them, a need which has not been met by the Trustees of the UMWA 1992 Benefit Plan.

The UMWA 1992 Benefit Plan is preparing to impose substantial security requirements upon 1988 last signatory operators under the terms of the Act. At the same time, the UMWA 1992 Benefit Plan has failed to develop and make available to the 1988 last signatory operators the managed care and cost containment rules mandated by the Act. This imposes a double penalty on the operator in that increasing costs, as evidenced by the Plan's set 31% increase for 1995, requires that higher security be posted and in that the operator is unable to implement cost-saving measures in its individual employer plan.

Unless and until the Trustees of the UMWA 1992 Benefit Plan have fulfilled their cost control obligations under the Act, no security requirements should be added to the already heavy burden placed on the 1988 last signatory operators by the Act. Additionally, legislation should be considered to force cost controls on the Trustees because of the excessive cost increases in the premiums.

Very truly yours,

Ralph Woods President

cc: Rep. John P. Murtha Sen. Rick Santorum Sen. Arlen Specter

RECORD STATEMENT BY LINDSEY COAL MINING COMPANY LIQUIDATING TRUST TO THE OVERSIGHT SUB-COMMITTEE OF THE HOUSE WAYS AND MEANS COMMITTEE CONCERNING THE 1992 COAL ACT

More than fifty years ago, between August of 1946 and August of 1952, a small Western Pennsylvania mining company, Lindsey Coal Mining Company, Inc., (Lindsey), employed less than 20 men on a full or parttime basis, many for less than a two year period. With the nationalization of the mines, Lindsey was required to pay into the "welfare and retirement fund" on a per ton basis, although Lindsey itself had never signed any BCOA agreement concerning these benefits. In 1952 Lindsey stopped mining, entirely and thereafter employed no miners, engaged in no mining activity, its only employee being one part-In the 1970s, Lindsey went into complete liquidation time clerk. (forming Lindsey Coal Mining Company Liquidating Trust) with all of its assets held in trust. The only income of Lindsey Liquidating Trust was passive in nature - royalty payments from gas leases, infrequent coal royalties and occasional sales of real estate. Monthly income now averages less than \$10,000.

In 1993, Lindsey Liquidating Trust was notified by the Combined Fund and the Social Security Administration that it was an Assigned Operator required to make payments to the Combined Fund or be subject to severe penalties. Lindsey Liquidating Trust has paid into the Combined

¹ There is current litigation in the United States District Court of the Western District of Pennsylvania at Docket No. 94-1043 concerning numerous challenges to the 1992 Coal Act. Court action involving this litigation has been pending January 1995 awaiting a decision on Motions for Summary Judgment. Copies of Briefs are available upon request.

Fund in excess of \$100,000 but has recently given notice that it may no longer be capable of making such payments after this summer due to drastically reduced income.

Although there is current legislation concerning relief for former mining operators designated as "Reachback companies", such proposed legislation is simply a moratorium upon payments because of the economic hardship caused those companies. We urgently request that Members of the Sub-Committee consider the drastic economic impact on Reachback companies. Remedial legislation should be implemented, not only in fairness to those entities caught in this oppressive web, but because the original legislation was fundamentally flawed and improper as applied to Lindsey and other companies in similar circumstances. The original intention of the 1992 Coal Act was to encompass only those companies which promised lifetime benefits to United Mine Workers. However, when the 1992 Coal Act was enacted, Congress incorrectly included within its purview, all companies that at anytime were affiliated with coal mining activity even though they never promised lifetime benefits.

The only argument that has been presented by the UMW Combined Fund in an attempt to justify inclusion of Reachback companies within the Coal Act, is that prior mine operators created "an atmosphere that promised lifetime benefits to those who would retire from the industry." However, even union mining companies did not promise lifetime benefits until 1978 when Lindsey Coal Mining Company was already of of business and in the process of liquidation. Therefore, how could a company such as Lindsey create an atmosphere of lifetime benefits when it was not even operating in the industry at that time?

Lindsey Liquidating Trust realizes the Committee will hear testimony from other Reachback companies as to the draconian effect of the 1992 Coal Act. We would hope Members of the Committee will correct the Act from the beginning and enact retroactive relief? Even by the broadest application of Constitutional principles, no free enterprise system can possibly survive if subjected to this form of intrusion by its government. There is much more at stake than "Reachback Relief." It is a question of Congress correcting a dangerous and confiscatory precedent.

Respectfully submitted,

Jeffrey Lundy, Esquire Attorney for Lindsey Coal Mining

Company Liquidating Trust

219 East Union Street P.O. Box 74 Punxsutawney, PA 15767 (814) 938-8110

We suggest the Committee examine analogous situations and decide whether Congress would ever conceivably apply such broad reaching legislation to other citizens. For example, in contemplating national healthcare reform would Congress even remotely consider legislation that required an amployer of a worker forty years ago, to pay premiums today for lifetime benefits of that former employee? Surely not.

STATEMENT FOR THE RECORD

Maxus Energy Corporation

Subcommittee on Oversight
Committee on Ways and Means
U.S. House of Representatives
Hearing on the Coal Industry Retiree Health Benefit Act
June 22, 1995

Maxus Energy Corporation is an independent oil and gas exploration and production company headquartered in Dallas, Texas. Maxus once owned and operated through its subsidiary, Gateway Coal Company, the Gateway Mine located in Green County, Pennsylvania. One of Maxus' predecessor companies acquired Gateway from two steel companies, both of which became bankrupt and defaulted on coal purchase agreements.

As a result of these bankruptcies, Maxus' predecessor lost over \$50 million on its brief ownership of the mine, which was closed in May of 1990. During the time the mine was active, United Mine Workers of America (UMWA) health benefits were provided as specified by the labor contract to which Gateway was a party. Currently, Gateway retirees receive health care benefits which are more comprehensive than those received by the retirees or employees of Maxus Energy Corporation. There is no charge for premiums, but these retirees provide about \$150 per year in copayments, according to the union's specifications.

In 1988, Gateway was an operator of a bituminous coal mine at which it employed hourly employees who were represented by the UMWA for bargaining purposes. Gateway became bound by the National Bituminous Coal Wage Agreement of 1988 (NBCWA) as a "me too"

signatory company, thereby accepting terms and conditions established in the 1988 NBCWA. The 1988 Agreement added a new wrinkle to the treatment of coal miner retirees by requiring, for the first time, that an employer ceasing operations must pay withdrawal liability to the multi-employer plans. Gateway was assessed and paid withdrawal liability of \$3,940,370.17.

As a result of the Coal Act of 1992, Gateway was assessed an additional \$5,180,526.95, and it is also currently paying premiums of \$115,107.54 every month. The combined Fund now holds Gateway's \$3.9 million withdrawal liability (as well as all of its other contributions), but will never accept any of Gateway's retirees. Instead, Gateway is required to maintain its individual employer plan for retirees perpetually and at its own expense.

H.R. 1370, the subject of the hearing, would amend the Internal Revenue Code to reduce the mandatory premiums to the UMWA Combined Benefit Fund by certain surplus amounts in the Fund. Maxus requests that we receive a credit against the cost of future premiums for the withdrawal liability payments previously made. Such a credit would put Maxus on the same financial footing as all other 1988 Agreement operators, i.e., we would be required to pay for the lifetime benefits of our retirees — we just would not be required to pay twice.

Thank you for your consideration of our request for equitable treatment in this legislation.



PALMER COKING COAL COMPANY

June 29, 1995

Phillip D. Moseley, Chief of Staff Committee on Ways and Means U.S. House of Representatives 1102 Longworth House Office Building Washington D.C. 20515

RE: Coal Industry Retiree Health Benefit Act of 1992

Hearing on Thursday, June 22, 1995 before Congresswoman Nancy L. Johnson's Subcommittee on Oversight of Ways and Means

Dear Mr. Moseley:

Our company is one of hundreds of victims of the Coal Industry Retiree Health Benefit Act of 1992, passed as a little-debated rider to the National Energy Policy Act. Our company left the coal industry nearly fifteen years ago and terminated our agreements with the United Mine Workers of America (UMWA). Upon termination in 1981 we paid the UMWA \$157,738.36 as part of our withdrawal liability. In addition, we ended up paying our attorney more than \$30,000.00 when we had to successfully litigate the UMWA's original miscalculation of our withdrawal liability.

In November, 1993 we received a letter from the UMWA and subsequently from the Social Security Administration informing us that we owed the UMWA another \$186,000.00. And each succeeding year our company has been billed a similar amount by the UMWA Health Fund. For a small company like ours, these kinds of liabilities are crippling. We left the coal industry fifteen years ago and now operate in business as a sand and gravel mining firm. Yet, thanks to the 1992 Act we face continuing liabilities for a situation which we did not create.

The 1992 law basically enacts an ex post facto tax to be paid by any company who was ever a signatory to a UMWA contract between 1950 and 1988. The tax is assessed by the Social Security Administration but paid directly to the United Mine Workers of America. A company who was signatory to a UMWA agreement is responsible for the health benefits of all retirees who last worked for that company. In the case of Palmer Coking Coal Company (Palmer), we were the last underground coal mine to operate in the state of Washington. As coal mines closed in Roslyn, Cle Elum, Wilkeson, Newcastle and Carbonado, miners from these communities came to our company in Black Diamond seeking employment during their last years of work. It was quite common for Palmer to hire 50

Coal Industry Retiree Health Benefit Act of 1992

year old, 55 year old, and even 60 year old coal miners seeking employment in the twilight years of their work life. These older coal miners came to Palmer several years away from retirement and usually worked to about age 65. Palmer, as a signatory to the UMWA contracts, assisted these elderly miners by giving them several years of employment during the period our company was phasing out our coal mines.

This accommodation of proud men in a declining industry has now come back to haunt Palmer. Though a miner may have worked thirty years for a different coal company in Roslyn, Palmer's employment of this man for the final two or three years before his retirement results in Palmer being liable for all of his (and his dependent's) health needs in retirement. As Palmer was the last coal mining company in Washington we now find ourselves responsible for scores of miners who spent most of their working years employed by other coal companies which went out of business and laid off their workers.

Palmer left the coal mining industry in the early 1980's but we did it honorably. All of our elderly UMWA coal miners were allowed to reach their retirement age before Palmer ended it's contract with the union. The 4 or 5 young men who were still employed in coal mining were transferred to new work in our gravel extraction business. All of our employees were treated honorably and with respect as we tried to meet their retirement needs. However, the UMWA, the large coal companies, and their friends in Congress chose to target innocent companies like us to bail out a mismanaged union health fund. And until the last of these retired miners (and their dependents) die, our company will be making monthly payments of \$15,000.00 to a union which we legally and financially left fifteen years ago.

An added injustice is the fact that as the "last signatory operator", Palmer Coking Coal Company is the "assigned operator" who is responsible for paying retired miners' health benefits. What this means is that although a coal miner may have worked twenty years for another coal operator, if he worked for Palmer Coking Coal Company during the last few years of his employment, Palmer is totally responsible.

Our company has requested from the Social Security Administration, the work histories of the list of miners assigned to us. We have been shocked to find that many of the assigned miners worked for Palmer for only 2 or 3 years out of a 30-40 year coal industry employment history. Yet under the "Coal Industry Retiree Health Benefit Act of 1992", Palmer is paying approximately \$3500 per miner or beneficiary, per year, to provide health benefits. In one particularly egregious case, a now-deceased miner worked for Palmer sporadically and part time over a period of four years. During this time period, Palmer paid about 5% of this man's total earnings. His total four year earnings from Palmer were a mere \$867 (1955-1958). Yet now, some 36 years later, Palmer is being

Coal Industry Retiree Health Benefit Act of 1992

assessed \$3500 per year in health benefits to this man's widow, a 57 year old, gainfully employed woman.

In another shocking example, Palmer Coking Coal Company, Inc. employed Waino Wakkuri in 1959 for a few weeks and he earned \$367.81. Now, some 36 years later, Palmer Coking Coal Company, a family partnership long out of the business of mining coal, must pay all of Mr. Wakkuri's widow's health and death benefits as administered by the UMWA Benefits Fund. Our cost this year for supplying said benefits will equal about \$3,500.00. And, we face continuing payments to the UMWA for future years.

The Coal Industry Retiree Health Benefit Act of 1992 is a cruel joke which has been visited upon hundreds of small companies like ourselves. This cruelty comes with a crippling price tag. This crippling price tag comes in the form of an unfair tax on small companies who have left the coal industry. The purpose of this unfair tax is to subsidize the big coal companies who comprise the Bituminous Coal Operators Association (B.C.O.A.) and their accomplices in the UMWA. We urge you to repeal this tax or at the very least exempt small coal companies from this pernicious "reachback" tax.

Very truly yours,

William Kombol, Manager Palmer Coking Coal Company

cc: Washington Congressional Delegation

Private Benefits Alliance

SUBMISSION OF THE PRIVATE BENEFITS ALLIANCE TO THE WAYS AND MEANS COMMITTEE OVERSIGHT SUBCOMMITTEE ON THE COAL INDUSTRY RETIREE HEALTH BENEFIT ACT OF 1992

The PBA (herein "the non-signatory companies") is a coalition of coal producers which never have participated in the United Mine Workers of America ("UMWA") Retiree Health Benefit program. PBA was formed in 1990 for the limited purpose of opposing legislative action to require non-signatory coal companies to finance other companies' UMWA retiree health care benefits. PBA's members are located in all coal mining regions of the United States, with their greatest production in the West. Some PBA members have collective bargaining agreements with unions other than the UMWA; others operate without a union.

The PBA companies participated in the legislative process which led to passage of the Coal Industry Retiree Health Benefit Act of 1992 ("The Coal Act"). This Act is the product of extensive negotiations and compromise. As the Committee recognized on page 3 of its July 22, 1995, Committee Print, notwithstanding their neutrality in the dispute and the economic disadvantage to them, the non-signatory companies agreed to the compromise under which up to \$70 million per year could be transferred from the Abandoned Mine Lands fund to supplement UMWA retiree health care benefits. This compromise was an alternative to proposals made by certain factions to levy a new tax on the entire coal industry. A large part of the burden of any such new tax would fall on non-signatory companies.

As an effort is undertaken to modify The Coal Act, PBA asks that the Committee be mindful of the entire history of legislative negotiations leading to The Act's passage and, particularly, that the non-signatory companies never have been a part of the UMWA retiree health care plans and had no role in contributing to their funding problems. While to date, we have heard nothing to suggest that changes under consideration could result in a tax assessment on an industry-wide basis or an increase in the amount of moneys now appropriated from the AML Funds to supplement the provision of benefits under The Coal Act, PBA writes this letter to record that it would strongly oppose any such proposal.

Now, as in the past, PBA objects to changes which would, or could, have the result, directly or indirectly, of imposing any obligation to finance the UMWA's welfare programs on the hundreds of non-UMWA coal industry employers who have managed their own benefit programs judiciously. At the June 22, 1995, hearing on this issue, several Committee members expressed their concern about the unfairness of assessing the super-reachback companies since they did not make the promises which are resolved by The Coal Act. This argument applies to an even greater degree to the non-signatory companies. PBA takes the position that the AML monies allocated to the Combined Fund should be eliminated and turned back to their originally intended purpose before any consideration is given to exemptions of any companies.

In any event, if changes are to be made, such legislation must also provide language guaranteeing that the non-signatory companies are exempt from The Coal Act and any new burdens to finance benefits for their competitors' employees.

STATEMENT OF PAUL W. MACAVOY ON BEHALF OF THE REACHBACK TAX COALITION

I. Introduction

A. Professional Background

My name is Paul W. MacAvoy and I am the Williams Brothers Professor of Management Studies at the Yale School of Management. My professional work has centered on regulation and strategic decision making by firms in the energy, transportation, and communications industries. I have authored numerous journal articles and sixteen books, including most recently Industry Regulation and the Performance of the American Economy (W.W. Norton 1992). I have served as a member of the President's Council of Economic Advisers. I have also served as a member of the board of directors for several corporations, including (currently) Alumax Corporation, American Cyanamid Company, the Chase Manhattan Bank Corporation, and LaFarge Corporation. My previous directorships include AMAX Corporation, a major American coal producer, on whose board I served for fifteen years up to this year. AMAX subsequently merged with Cyprus AMAX.

B. The Reachback Tax Issue

This statement is presented on behalf of the Reachback Tax Coalition, a group of companies mandated by the Coal Act of 1992 to contribute to a health benefit plan (the "Combined Fund") for retirees of the United Mine Workers Association ("UMWA"). The Coal Act has two major aspects: the first requires contributions from sources other than signatories to the 1988 National Bituminous Coal Wage Agreement ("NBCWA") to the UMWA Combined Health Care Fund, and the second is a Reachback provision which provides that companies that had signed a NBCWA contract at any time since 1950, but not the 1988 NBCWA contract (the "Reachback" companies), are now required to contribute to the Combined Fund as well. The primary purposes of my statement are to analyze the economic justification for the Coal Act's requirement that Reachback companies make contributions to the Combined Fund and to assess the overall consequences of the Act. In preparing this statement, I have reviewed a number of materials, including the Coal Industry Retiree Health Benefit Act of 1992 ("Coal Act", or "Rockefeller Act"); Congressional hearings on UMWA health benefits; the Dole Commission Report on the Coal Industry; testimony of witnesses appearing before this Committee; and court decisions relating to the Coal Act and UMWA retiree henefits.

II. The Appropriate Role for Federal Intervention in the Operation of an Industry

In passing the Coal Act, Congress imposed a new federal tax policy mandating which companies would contribute to the Combined Fund to provide lifetime health benefits to retirees of the UMWA. Before considering the details of how the Coal Act has operated, it is important to step back and ask whether such intervention by the federal government can be justified.

From an economic policy perspective, government intervention in the operation of an industry is justifiable only when it serves to solve a market failure or rectify a circumstance of incomplete contracts. Prime examples of market failures include the market's inability to take account of externalities, such as air pollution caused by a manufacturing plant, or a market's inability to prevent monopoly prices. In such instances, federal intervention can potentially rectify the market failures, through such mechanisms as the imposition of taxes in the form of effluent charges and antitrust actions to prevent the exclusionary use of market power by monopolies.

Federal intervention in an industry can also help to ameliorate problems between private parties in circumstances in which contracts fail to specify the actions that should be taken given certain outcomes. In the current context, two rationalizations of this type were offered to justify federal intervention in the form of the Reachback provisions of the 1992 Coal Act. First, the health benefit plans were allegedly so deficit-ridden as a result of unforescen circumstances that only federal intervention could prevent their financial collapse. Second, so-called "orphan" workers were allegedly in danger of not being covered or, alternatively, of having the costs of their coverage bestowed unfairly on the companies still part of the agreement, thereby threatening its continuation or renewal.

Both of these rationalizations were factually without foundation at the time Congress passed the Coal Act in 1992. There was no justification for this type of dramatic federal intervention in the coal industry.

In 1992 the extant collective bargaining agreements between coal companies and the UMWA reflected their efforts over time to reach equitable divisions of wage and benefits compensation to workers. Since companies and employees historically and predictably exited from the bituminous coal industry over time, these wage and benefit negotiations necessarily involved both past and future generations of firms and workers in the industry. Since the 1930s, labor relations in this industry have been tumultuous and, at times, violent. They have involved intense struggles over health and pension benefits just as much as wages. However, negotiations were always internalized just to those companies and workers who benefitted from NBCWA contracts.

Being a part of the bargaining process leading to a contract was essential for a unionized producer of bituminous coal. For parties to that process to go outside of the terms of a voluntarily negotiated wage and benefits contract to tap other, unrelated sources of funds to either decrease the cost obligation of signatories to the contract or increase the negotiated wage and benefits package is not any more justifiable for the coal industry than it would be for any other industry. If this were to become a general practice, it would lead to large and serious misallocations of resources across the national economy.

It might be argued that orphans "dumped" by exiting companies on remaining firms constitute an example of an incomplete contract for which federal intervention in the market is required. This argument also is factually incorrect. The voluntarily negotiated NBCWA contracts explicitly took into consideration the possibility that firms would exit the industry. Before the mid-1970s, the UMWA pension and health benefit programs were both combined in one union-run "pay-as-you-go" plan financed by multi-employer contributions assessed on a per unit of production basis. An employer's obligation to contribute stopped when it exited the industry or otherwise ceased to be a signatory to the contract. In 1978 when each employer prospectively took on the responsibility of providing health benefits to its current employees and future retirees, a multi-employer plan was set up specifically to cover the cost of providing health benefits to workers "orphaned" when their former employers left the industry. Thus, there was no incompleteness to the contracts along these lines. Government intervention to provide for such "orphans" in the form of taxing firms who previously exited the industry was, therefore, completely unjustified.

Some analysts have cited prior actions by the federal government in the coal industry and argued that those actions in some way justify federal intervention in matters regarding health care benefit agreements between coal companies and the UMWA. For example, in his September 1993 statement before the Ways and Means Committee, Richard Trumka, President of the UMWA, noted that the Truman Administration ended a coal strike by seizing the coal mines for a year and argued that this intervention began a continuing government commitment to improved health care in the nation's coal fields." Mr. Trumka was correct that the federal government has from time to time attempted to prevent or control the economic disruption resulting from coal strikes even to the extent of President Truman's seizure of the mines. The government has, also at times, in an arbitration role assisted in negotiation of health care agreements between coal companies and the UMWA. However, in the immediate aftermath of the seizure of the mines and during the five decades until the Rockefeller Act, the government has explicitly made clear that questions of wages and benefits were subject to the process of collective bargaining. The actions on the part of the federal government in helping to settle strikes have never involved the imposition of specific contract terms and in no way create a precedent for the type of federal intervention such as that undertaken in the 1992 Coal Act. Indeed, there was no strike in 1992. Mandating that Reachback companies contribute to the Combined Fund was not part of a strike settlement process; rather it resulted from skillful political use of the legislative process to root out and supplant the results of more than forty years of collective bargaining in a manner never undertaken before in the coal industry, much less any other industry.

Mr. Trumka's justification for federal intervention taking the form of the Reachback mandate was that "every company still in existence with assets to provide for the promised health care was justly asked to step forward and pay for the cost of providing health care to its retirees." Since this would necessarily involve asking Reachback companies with no continuing financial obligations to fund the proposed health care plan, Mr. Trumka correctly, albeit ironically, noted: "Obviously, there was no way for private parties to achieve these ends. We needed congressional intervention." The obvious reason was that government compulsion was necessary to extract payments from firms

that had already complied with all of their legal liabilities before exiting the bituminous coal business. The need for legal force to achieve a desired economic result is hardly an adequate reason for federal intervention in private sector industry.

III. The Specific Rationale for the Coal Act in 1992

In the absence of a principled justification for federal intervention, special reasons were advanced by the Act's supporters at the time of its passage in 1992. They, too, are entirely specious. Advocates stated that there was a funding crisis and that unacceptable levels of "orphan" retirees threatened the collapse of the UMWA funds. Both of these reasons were factually wrong.

A. The Alleged Crisis in Funding Retiree Health Benefits

At the time the Congress was urged to pass the Coal Act it was told that there was a large and growing deficit in the UMWA Health Benefit Funds which jeopardized the continuation of retiree health benefits. The source for this proposition, the Dole Commission, reported that there would be a \$300 million deficit in the health benefit funds by the end of 1993. In response, the Coal Act contained a provision requiring the 1988 signatories to pay off the deficits before the statutory Combined Fund took over the funds.

This provision was never used, however, because the deficit (\$114.3 million at the end of 1991 according to the General Accounting Office) was reduced to \$58.4 million by the end of 1992. Thereafter, through collections and expenditure adjustments, the trustees retrospectively found in November 1994 that by Jamuary 1993 the fund had in fact moved to a \$16.7 million surplus. This result had been achieved as a result of a comprehensive injunction issued by Judge Glenn Williams in federal court in Abingdon, Virginia which required: (1) the Bituminous Coal Operators Association ("BCOA") to increase their rate of funding of the 1950 and 1974 health benefit trusts as provided for in the "guarantee" clause in the 1988 contract; (2) the trustees to require all eligible beneficiaries to sign up for Medicare; (3) the trustees to stop paying more than Medicare contract rates to reimburse Medicare providers; and (4) the trustees to provide health benefits for the remainder of the 1988 agreement until February 1993.

Judge Williams also wryly observed that the BCOA had argued against the injunction on the grounds that dire consequences would flow from it — "the Rockefeller bill would be defeated and the BCOA because of its small size would be eliminated." The cynical nature of this argument is readily apparent. Indeed, it appears that in fact the alleged fund deficit was wholly akin to numerous political myths, e.g., the Kennedy missile gap of 1960, in that it simply never existed. This conclusion is supported by a recent study of the expected future balances of the Combined Fund performed by Towers Perrin, a prominent international benefits and compensation firm, which finds that the fund will have a cumulative surplus by September 2004 of approximately \$289 million.

B. The Alleged Dumping of Orphan Retirees as Creating an Insuperable Financial Burden on the BCOA

The allegation that certain companies had created a financial crisis for the funds by dumping their orphan retirees on the BCOA companies was accepted uncritically by some interested in the passage and subsequent defense of the Coal Act. This allegation has been used to mask the reality of a clear exercise of political and legislative power by the BCOA in cooperation with the UMWA to transfer to others a large amount (approximately \$123 million annually, consisting of \$53 million from Reachback companies and \$70 million from the federal Abandoned Mine Lands trust) of its costs for retiree health care established under prior collective bargaining agreements.

The claim that dumping of orphans endangered the financial stability or the continuation of health benefit funds cannot withstand scrutiny. The 1950 Health Benefits Trust which covered all pre-1976 retirees was a multi-employer plan which by definition never had "orphans." All retirees received their health benefits from the fund directly and any retiree's benefits were not related to any particular employer. This fund was always financed on a current production basis by current signatories to the most recent NBCWA. The Rockefeller bill by its assignment of 1950 fund beneficiaries to prior employers accomplished a wealth transfer to the BCOA companies from the Reachback companies without any orphan dumping justification. The 1950 Health Benefits fund was simply where most of the beneficiaries – some 80% and thus most of the expense – were located

The question of orphans only arose with respect to the 1974 Health Benefits Fund. In 1974, the ERISA statute was passed and was in 1980 definitively extended to multi-employer agreements. As this statute applied only to pensions, it dictated the separation of the health and benefit funds into separate trusts for the first time. In the same time frame, while negotiating the 1978 NBCWA, the BCOA insisted in taking back the management of health benefits from the Funds because of its belief that control of benefits administration by each signatory company would end two decades of waste and abuse by the Funds.

Under the 1978 NBCWA, each signatory company was henceforth responsible for providing the contractually agreed level of benefits to each of its own active employees and retriees. At the insistence of the UMWA, the 1974 Health Benefits Fund was retained to provide benefits for all "orphan" retirees and their beneficiaries who retired after the 1950 Fund closed in January 1976 from companies who left the industry. In 1976, for the first time, at the insistence of the BCOA, individual companies became responsible for the health care of their active employees and their retirees who were not covered by the 1950 Fund. Thus, it is only with respect to the retirees in the 1974 Fund, a relative handful, that the concept of orphan had any relevance.

But the Rockefeller Coal Act not only addressed the problem of the 1974 Fund orphans but undertook a massive restructuring of liabilities for the 1950 Fund as well. The numbers of retirees in the 1974 orphan category was relatively modest – approximately 16,000 – as compared with the 100,000 in the 1950 Fund, and was financially manageable by the BCOA signatories under then current contractual arrangements. In addition, the anticipation that the number of "orphans" would greatly increase if other firms with large numbers of retirees were to leave the industry was in fact addressed in the 1988 agreement by imposition of contractual withdrawal liability upon signatory firms later exiting the industry. Thus, the Combined Fund and the Reachback taxation process instituted by the Rockefeller Act was in no way necessitated by the problem of future withdrawals by BCOA signatories.

In his 1993 testimony, Mr. Trumka repeated the claim that dumping of orphans "on a dwindling number of signatory companies" led to a crisis necessitating government intervention. But in fact production by signatory companies in the 1979 to 1989 period leading up to the Coal Act was quite stable, so that total payments into the fund were stable. Indeed, a significant number of BCOA firms were simply acquired by the BCOA firms remaining in the industry. Thus while it was the case that the absolute number of BCOA firms had declined, the remaining firms produced, on average, enough additional coal to make fund payments to replace those of the exiting firms. There was no reason to expect that remaining firms would fail to carry out the contractually agreed upon provision of health care benefits for workers orphaned by the exit of firms from the industry.

IV. Adverse Consequences of the Coal Act

A. Reachback Firms Are Unjustifiably Required to Contribute Large Sums of Money

The first adverse effect of the Reachback provision of the Coal Act is the direct one that Reachback companies are taxed at the rate of approximately \$53 million per year. Table One presents data for several publicly traded Reachback companies on their lines of business and revenues, while Table Two describes these lines of business in more detail. As is clear from the tables, the firms currently produce many different products, most having nothing to do with bituminous coal production. For example, Allied Signal's business lines are in the automotive, aerospace, and engineered materials industries. Their production of such items as anti-submarine warfare systems is leagues away from the bituminous coal industry. Likewise, Union Carbide's chemicals and plastics operations, encompassing the production of such items as materials and systems for printed wiring and circuit boards, in no way relates to coal mining.

The annual financial obligations under the Coal Act of these Reachback companies are also shown in Table One. These payments range from six hundred thousand dollars for Union Carbide to over twelve million dollars for LTV. While these payments are not so large as to threaten the financial stability of these companies, they make no economic sense. Effectively, a tax for coal retirees' health benefits is being levied on sales of cockpit data recorders and automatic coffeemakers.

TABLE ONE REVENUES, LINES OF BUSINESS, AND ANNUAL LIABILITIES FOR SELECTED REACHBACK COMPANIES, 1994

			Reveaue by	Assuel
Company Name	Total Revenue	Lines of Business	Lines of Business	Reachback
	(*000,000*)		(#000,0000)	Liability
Altico Signal, Lat.	\$12,817	Astomotive	\$4,922	
	ļ	Acrospect	\$4,623	\$2,100,000
		Engineered Materials	\$3,272	
Cleveland Cliffs, Inc.	\$379	Iron Ore and Other	\$379	\$840,256
LTV Corp.	\$4,529	Sacci	\$4,230	\$12,100,000
		Escrity Products	\$299	
Lone Star Technologies	\$357	Official Products and Services	\$215	\$834,732
		Industrial Products	\$142	
Maxus Energy Corp.	\$682	On and Offshore Oil and Gus	\$682	N.A.
NACOD Industries, Inc.	\$1,965	Meterial Headling Equipment	\$1,179	\$2,868,600
	Į.	Small Electrical Appliances	\$377	
		Lignite Mining	\$250	
		Retail Kitchenware and Appliances	\$64	
		Other Operations	\$1	
Union Carbide	\$4,865	Chemicals and Plastics	\$4,865	\$594,269

TABLE TWO
DETAILED LINES OF BUSINESS OF SELECTED REACHBACK COMPANIES

Company Name	Detailed Lines of Business
Allied Signal, Inc.	Designa, develops, massefactures, markets and services aerospace products including aircraft angians, environmental control systems, corchité data recorden, space-pointing devices and control systems for spacecraft and anti-submarine warfare systems; designs, engineers and manufactures automotive products such as braiking systems, engine components and safety restraint systems; develops, produces, and markets specialty engineered materials including sylon, fluorine products, onlines, resins, specialty films and circuit board laminates.
Cleveland Cliffs, Inc.	Controls, develops and lenter iron ove and coal reserver; manages and owns interest in miner; owns interests in a railroad providing services to the miner, and produces and selfs coal and iron ove pellets.
LTV Corp.	Produces and selfs steel and related steel items; manufactures and distributes drilling and production equipment; distributes seamless steel tubular products and cilified supplies.
Lone Star Technologies	Holding company with subsidiary which manufactures and markets oilfield casting, tubing, line pipe, specialty tubing and flat rolled steel.
Maxis Energy Corp.	Holding company with subsidiaries which explore for and produce oil and gar; purchase, gather and process natural gar; and produce natural gas liquids.
NAACO Industries, Inc.	Hoding company with subsidiaries which design, manufacture, and market fortifit tracks and selected service parts; manufacture and market small electrical appliances such as blenders and food processors; some and market lignite coal for use by electric utilities; and operate specialty retail stores offering histonomere, small appliances, and related accessories.
Union Carbide	Hodding company with subsidiaries which produce ethyleae coide/glycol; manufacture broad range of derivatives of ethyleae coide/glycol; supply solvents, resins, intermediates, emulsions and additives to a broad variety of markets; manufacture and supply specialty chemicals; provide materials and systems for printed wiring and circuit boards; supply process technology, catalysts, molecular sieve absorbeats, process plants and technical services to the petrochemical and gas processing industries.

The Coal Act's effects on smaller companies has in many instances been more direct and more severe. Table Three contains brief descriptions of some of the more egregious examples of the arbitrary nature of the tax. The Act requires Princeton Mining Co., for example, to contribute even though it ceased coal mining operations in 1966 and currently produces and distributes

popcorn. Another payer under the Act is 41 Liquors, a liquor store owned by the widow of a man who ran a construction business that worked on union mines. Ohio Mining Co., another Reachback firm, is the a real estate developer that ceased mining operations in 1951. Ohio Mining was assigned five retired mine workers, only one of whom actually worked for the company, as well as fifteen dependents.

TABLE THREE
SELECTED REACHBACK CASE STUDIES

Company	Case Suttitibary
Carpentertown Coal & Cobe Co.	Curpentertown filed for bankruptcy protection in June 1989. It was assigned 225 beneficiaries
Tucson, AZ	at a cost of \$760,229 per year.
Bear Coal Co. Inc.	Bear Cost is a family-owned, union-operated coal mining butiness that was assigned 29
Somereet, CO	beneficiaries despite a 1984 collective burgaining agreement, and a \$1.1 million withdrawar
	peanity, which removed its obligation to the benefit trusts. Its assigned premium of \$91,896 per
	year translates into a liability over the next ten years equal to approximately 25 percent of its
	net worth.
Bolimeier Construction Co.	Misse-related construction and maintenance accounts for 80 percent of this family-run
Marissa, IL	company's business. Bolimeier's assigned premium is approximately \$38,000 per year.
CB&I Industries	CB&I Industries is a Portune 900 construction business that was assigned beneficiaries who
Oak Brook, IL	were employed as painters, laborers, and boilermakers for several weeks during the period 1950
	to 1980. Its assigned prezaivan is \$24,000 per year.
Princeton Mining Co.	Princeton Mining ceased mining cost in 1966. Its primary business is now growing, processing.
Terre Haute, IN	and wholesale distribution of popcorn. It was assigned 41 beneficiaries at a cost of \$419,325
	per year.
41 Liquors	This liquor store belongs to the widow of a man who once ran a construction business that
Madisonville, KY	performed work for union mines. 41 Liquors' assigned premium is approximately \$9,600 per
	Now.
Charbon Bridge	Charbon Bridge is a highway construction firm that was assigned five beneficiaries at a cost of
Madisosville, KY	\$18,000 per year. One of the assigned beneficiaries worked for the firm for 48 hours.
The Ohio Mining Co.	Onio Mining is a real estate development business that ceased mining operations in 1951. It
The Plains, OH	was assigned five retired miners, only one of whom worked for the company, and 15
1	dependents at an annual cost of \$67,326.
Bernes & Tucker Co.	Surnes & Tucker was assigned a premium of \$2.6 million annually, approximately twice its
Bdensburg, PA	annual gross reveaues.
Dantella Brothers	Dantella Brothers previously operated a coal-stripping business, but withdrew from the union
Kitanning, PA	is 1962. It is now a small earth-moving and construction company. It was assigned two
j	hemeficienies, one of whom operated a truck the company reated to a union coal operator in
	1948, at an annual premium of \$6,957 per year.
GAL Construction Inc.	GAL has receasily come out of bankruptcy and was assigned a premium of \$27,829 per year.
Belle Verson, PA	
Lanzendorfer Trucking Co. Inc.	Lazzendorfer Trucking is a family trucking business that formerly hauled union coal. In 1987,
Twin Rocks, PA	it withdrew from the union and paid a withdrawal penalty. Lamendorfer's assigned premium
1	of \$24,350 per year equals approximately twenty percent of its payroll, which forced the
}	company to file for bankruptcy.
	L

TABLE THREE (CONTINUED) SELECTED REACHBACK CASE STUDIES

Сотрану	Case Summery
Morris Rue Coal Mining Co.	Morris Russ Coal Mining terminated deep mining more than 40 years ago, then produced coal
Wilkes-Barre, PA	under contract with a strip-mining operator until 1983. It is responsible for one retired miner,
ļ	who worked for them for approximately five months in 1952, as well as his five dependents.
New Shamet Mining Co.	New Shampit Milning exited the coal business and currently has no employees. It was assigned
Clearfield, PA	106 retired miners and 84 dependents at an annual cost of \$461,642 per year.
Seger Coal Co.	Segar Coal is a sole proprietorship construction business that was assigned 14 beneficiaries,
Belle Vernos, PA	with an assigned premium approximately double the firm's annual gross income. Sager Coal
	stopped mining in 1967 and signed its last UMWA contract in 1964. When Mr. Jeff Sager
	bought the business from his father in 1989, its assets consisted of the firm name and two
	pieces of real estate.
TASA Corp.	TASA was assigned seven beneficiaries at a cost of \$24,000 annually, or approximately 25
Fittaburgh, PA	percent of its income. TASA last mined cost more than 30 years ago.
Unity Real Estate Co.	Unity has exited the coal industry. Its annual assigned premium was \$266,000, which compares
Greensburg, PA	with its annual gross income of \$54,000.
Clinchfield Conl, Jewell Ridge	Clinchfield Coal and Jewell Ridge Coal are subsidiaries of Pittston, whose total Reachback
Coal	liability is \$12 million annually.
Lebanon, VA	
DO&W Coal Co., Inc.	DO&W conducts contract coal mining for the Pittston Coal Group. DO&W emerged from
Clincheo, VA	Chapter 11 reorganization in November 1993, and was assigned an annual premium of \$111,315.
Bik Horn Coal Corp.	Bik Horn Coal last mined coal with union labor in 1985 and now primarily lesses coal mining
Richmond, VA	rights. It was assigned 210 beneficiaries at a yearly premium of \$708,048.
KWC, Inc.	KWC is a small trucking and hauling business. It was assigned beneficiaries as a result of
Whitewood, VA	operations in the 1970s when it hauled refuse from a union mine. Its annual premium is
	\$6,957.
Mary Helen Coal Corp.	Mary Helen Coal last mined coal in 1962. It was assigned 84 beneficiaries at an assurat cost of
Blackstone, VA	3294,660 per year, which exceeds its annual royalty income by a factor of twelve.
Milburn Collieries	Milbura Collieries stopped mining coal approximately ten years ago. Its Reachback tax
Lynchburg, VA	assessment is \$212,000 annually. The company anticipates filling for bankruptcy within two
	years.
Palmer Coking Coni Co.	Palmer Coking was the last underground mine to operate in the state of Washington, so under
Black Diamond, WA	the "last employer" provision of the Coal Act, it was assigned many beneficiaries who apens
	most of their working years employed by other coal companies. The company ceased mining in
	1981 and paid a withdrawal penalty to UMWA. It is now a sand and gravel concern with an
	annual Reachback bill of \$185,599.
Mountain Lauret Resources	Mountain Laurel Resources filed for bankruptcy after being assigned more than 1,500
Mount Hope, WV	beneficiaries at an annual cost of \$5,217,378.

Several of these companies have either been forced into bankruptcy or face that outcome as an imminent prospect. These companies include: (1) Carpentertown Coal and Coke, which was actually in bankruptcy at the time it incurred an annual health care bill of approximately \$750,000; (2) Barnes & Tucker Co. which was assessed \$2.6 million annually, approximately twice its total annual revenues; (3) Lanzendorfer Trucking Co., a trucking company that formerly hauled union coal, whose annual assessment equals approximately twenty percent of its payroll; (4) \$&D Coal Co., which formerly hauled union coal; (5) Sager Coal Co., a construction company that ceased coal mining in 1967 but whose Reachback assessments are approximately twice its gross income; and (6) Mountain Laurel Resources, which filed for bankruptcy after being assigned more than 1,500 beneficiaries. In sum, as the examples from Table Three demonstrate, the effects of the Reachback tax have been both devastating in their effects and bizarre in their circumstances.

B. Precedent for Future Congressionally Mandated Takings

The Reachback tax is a classic example of a government taking. The precedent set here is that in alleged future instances of market failure or incomplete contracts, any company that ever produced anything related to the product in question will be subject to takings. In the extreme, a Congressional effort to clean up nuclear weapons sites would tap a firm like Colt Industries, which produced repeater firearms in 1915, because Colt was involved in the weapons industry and was a previous signatory to a labor agreement that later covered nuclear plant technicians. An even closer analogy would be if the Social Security Trust Fund were facing an underfunding crisis and Congress tapped companies and retired individuals who had previously made payments, using the justification that they now should contribute because they once had done so. The disincentives provided to existing firms by the expost adverse consequences of other actions consistent with this precedent are difficult to quantify but are obviously major and substantial.

A second adverse incentive provided by the Reachback provision is that firms active in an industry will be induced to underfund private benefit plans. The Reachback provision signals these firms that by causing funding crises, they can encourage Congress to tax unrelated entities to bail out the plans. Firms active in an industry can thereby transfer financial obligations to third-party entities having no legal or economic responsibilities for the artificially created funding crisis.

Indeed, it was recently proposed to finance health and pension costs for the auto industry through an excise tax on each car sold in the United States. The funds generated by this tax would establish an auto industry health and pension stabilization fund whose proceeds would be allocated by the fund administrators in such a way as to equalize these costs among domestic, U.S., and foreign auto manufacturers (Economic Strategic Institute. The Future of the Industry: It Can Compete, Can It Survive, 1992). This is a first step; but with the extension of the Reachback precedent, given a funding crisis deliberately induced by current members of the industry, past car manufacturers such as American Motors, International Harvester, or any discoverable corporate descendants could be required to pay for health benefits of past retirees.

The clear nature of the Reachback tax as a taking was confirmed in a January 1995 decision by the U.S. District Court (W.D. Penn, Unity Real Estate Company v. Marty D. Hudson, et al.) when it granted an injunction to restrain enforcement of the Coal Act against Unity Real Estate Company (*Unity*). Unity is a small family-owned business, whose predecessors included coal mining companies, notably South Union (West Virginia) and South Union (Pennsylvania). Their coal-mining predecessors operated during the period from 1922-1981, and were signatories to NBCWA contracts from 1950 through 1981. Unity was forced by the Coal Act to cover the health care of 78 beneficiaries in 1993, and 76 more in 1994. These beneficiaries were former employees (or survivors of former employees) of South Union (West Virginia) and South Union (Pennsylvania). The Reachback taxes imposed by the Coal Act for a single year (\$266,000) were so large as to eclipse Unity's total net worth (\$85,000). In fact, Unity did not even have sufficient cash on hand to be able to meet the first month's mandated premiums.

Facing certain bankruptcy, Unity brought suit against the Trustees of both the UMWA Combined Benefit Fund and the 1992 UMWA Benefit Plan in U.S. District Court. The Court concluded "that the Coal Act violates the Takings Clause of the constitution." Further, the Court found that "the Coal Act as applied to Unity is so palpably unconstitutional that a preliminary injunction should issue against the enforcement of the Act against it."

The Court was especially aggrieved that the Reachback provision of the Coal Act was able to stretch so far back into the past. Although defendants argued that Unity could have reasonably foreseen its future obligations to their predecessor's employers, the Court responded that if "the

possibility of a decade-later legislative solution to a crisis makes the imposition of liability on Unity on some basis chosen by Congress constitutionally foreseeable, then the expectations prong of the Takings Clause analysis ceases to exist, because legislation can always be foreseen. Specifically, "[t]o expand that reach to a period in excess of a decade goes far beyond any constitutional power of Congress."

To determine whether a taking has occurred is in the domain of the court system and not part of my expertise. Yet in the case of takings, the relevant issues at hand are fundamentally economic ones, and economic analysis can prove enlightening. Although some would argue that a taking impacts only the entity against whom regulations are promulgated, the effects of a taking clearly extend beyond the corporation itself. In the opinion of Baumol and Sidak, the confiscation of property without adequate compensation in the case of a corporation must be viewed in economic terms as the taking of the property of the stockholders (Harvard Journal of Law & Public Policy, Vol. 18). Thus, one method of economic analysis to determine whether an action constitutes a "taking" is to examine the stock prices of companies. Again, according to Baumol and Sidak:

If the price of the regulated firm's stocks had been moving for some considerable period in a manner that seems in line with the stock prices of fairly comparable enterprises, then a sharp drop in the relative price of the securities of the regulated firm in the wake of a substantial change in regulatory policy creates a strong presumption that the regulatory charge is confiscatory. In other words, if the securities price is driven out of line with the prices of similar securities of comparable firms, it is the market's verdict that confiscation has occurred.

Certainly, the imposition of a Reachback tax that forces a company such as Unity into bankruptcy is clear proof that the market believes that a taking has occurred. A burden as weighty as the Reachback tax is not likely to have been shouldered by Unity's competitors, who will now operate in a less competitive marketplace due to the loss of a rival. Society becomes the loser, because, as stated by Baumol and Sidak, "[w]hatever the means by which such regulatory restrictions on investor compensation are imposed, they confiscate from consumers and investors alike what is legitimately theirs — the benefits that they can expect in any competitive market, and which they are denied only by the caprice of the regulatory process."

C. Reachback Taxes Distort Prices in Non-Coal Markets

Mandatory contributions on Reachback firms are taxes on the operations of companies throughout the economy. Some of these companies currently mine other types of coal, e.g. lignite, while other firms have exited the coal industry altogether. These taxes distort prices in unrelated markets and reduce the ability of Reachback firms to compete in those markets against firms not subject to the Reachback provision. Some Reachback firms have been more than just competitively disadvantaged — they have been forced into bankruptcy as a result of the Act. Thus, in some instances the Reachback provision has resulted in taxes so confiscatory in nature that firms have been forced to disband their operations despite the fact that they were surviving in their respective marketplaces by providing valuable products at competitive prices. This means these now bankrupt firms were employing scarce factors of production in their highest-valued uses, thereby increasing the welfare of society, but the Reachback provision imposed such severe competitive disadvantages on them that they could not survive. This is an undesirable outcome: Efficient firms were effectively destroyed by the Reachback provision, resulting in a diminution of society's welfare.

D. Reachback Companies Had No Expectation They Were Liable for Future Contributions to Health Care Benefit Plans

Reachback companies had no expectation that they would be liable for future contributions to health benefit plans when they were no longer signatories to an NBCWA contract. If the companies believed they had such financial obligations, they would have disclosed those obligations in their 10K reports so as to prevent lawsuits by shareholders claiming the companies had not fully disclosed relevant information that could affect their future earnings. I have examined the 10K reports of all publicly traded, Reachback companies that no longer had an NBCWA contract in 1988 and found that none of these companies stated they had a continuing financial obligation to fund health benefit plans of UMWA workers. The decision by Congress in 1992 to impose contribution requirements on Reachback companies was a confiscatory tax which neither the companies nor the capital market had expected.

Despite the fact that none of the publicly traded, Reachback companies show any evidence of recognizing a continuing financial obligation to fund heath care benefit plans under the terms of their (prior to 1988) NBCWA contracts, Mr. Trumka in his 1993 statement concluded in no uncertain terms that the Reachback companies did have such continuing financial obligations. Mr. Trumka noted that Chairman Rostenkowski and others had suggested that "it might not be fair to impose retiree health care liabilities on former coal industry employers." However Mr. Trumka dismissed this opinion with the commitment that Reachback companies, as well as signatories to the 1988 NBCWA, "made the commitment to provide lifetime health care benefits to [their] employees [and so] would be liable for premiums under the [1992 Coal] Act. Mr. Trumka's statement is contradicted by two basic facts. First, the explicit terms of the 1988 NBCWA contract specified, under the guarantee clause, that health care benefit plans were in existence for the life of the contract — not the lifetime of the employees. Second, the 1988 NBCWA contract could not place health care liabilities on Reachback companies who, by definition, were not signatories to the contract. If it could have, obviously the Rockefeller Act would not have been required.

V. Conclusion

Federal intervention in the coal industry in the form of the 1992 Coal Act has no economic rationale. The Reachback provision was, and continues to be, an unjustifiable tax on other firms that lowers the cost of health care payments by coal companies that signed the 1988 NBCWA contract. The tax is unjustifiable because it solves neither a market failure nor a contractual incompleteness problem. The Act was passed to solve an alleged funding crisis which never existed and to fund the benefits of orphan retirees whose health care benefits were already contractually provided for in existing health benefit funds. In sum, Reachback provision of the Coal Act deserves no place on the rolls of required government interventions in the marketplace. Its potential for surviving as a model for arbitrary and confiscatory taxation throughout the economy is substantial. It should be repealed.

STATEMENT OF JONATHAN C. ROSE OF JONES, DAY, REAVIS AND POGUE ON BEHALF OF THE REACHBACK TAX RELIEF COALITION

WHO PROMISED WHAT TO WHOM WHEN?

AN ANALYSIS OF THE ACTUAL CONTRACTUAL OBLIGATIONS OF CURRENT AND FORMER SIGNATORIES UNDER THE COAL WAGE AGREEMENTS

The Coal Act of 1992, according to those who would preserve it from any amendment, is founded on the premise that "all companies which employed the retirees should not be allowed to escape paying for the promised retirement health benefits and dump their responsibilities on their competitors." The BCOA and other supporters of the Coal Act have remained necessarily vague and ambiguous, however, about the source of those claimed promises and responsibilities. To the extent they have not simply manufactured the claimed responsibilities, the supporters of the Act rely on several clauses inserted in the National Bituminous Coal Wage Agreement (NBCWA or Wage Agreement) and the UMWA plan documents in 1978. Clearly, whatever is contained in those clauses can have no application to those 158 Reachback companies that did not sign the 1978 NBCWA or a later agreement, as they never passed on, much less agreed to, those provisions. As set forth below, those clauses provide no greater warrant for concluding that the reachback signatories of the 1978 and later Wage Agreements made any promises that support the liability imposed by the Coal Act.

For more than forty years, health benefits in the unionized sector of the bituminous coal industry were provided through a multi-employer plan and funded on a pay-as-you-go basis through contributions from all current signatories of the Wage Agreement. Each employer contributed from day one, regardless of how many (or whether any) of the retirees drawing benefits had worked for it. The duty of any specific employer to contribute to the plan was always expressly limited to the term of the current agreement and ceased when that employer ceased to be a signatory. The promise to pay benefits to retirees in 1950 Plan was always the promise of the industry-wide plan, not of any individual employer. Even after the creation, prospectively, of single employer benefit plans in 1978 for current employees and post-1975 retirees, a multi-employer plan was retained to pay the benefits for those beneficiaries who otherwise would cease to receive benefits.

Sponsors of the Coal Act simply tore up the collective bargaining agreements underlying the multi-employer benefits system that had served the industry well since 1950 and reallocated the employers' and former employers' obligations by legislative fiat. Pre-1976 retirees and their beneficiaries, who had always been the responsibility of the 1950 UMWA Benefit Fund, funded by the signatories of the current NBCWA, were arbitrarily reassigned to former signatories, most of whom had been out of the bituminous coal business for years. Post-1975 retirees and their beneficiaries, whom the courts had unanimously determined to be the responsibility of the 1974 UMWA Benefit Fund, were similarly reassigned to their former employers, although the collective bargaining agreements those employers had signed clearly retained the 1974 Fund funded by current NBCWA signatories to provide their benefits. Through this mechanism, the BCOA managed to shift the liability for more than 25,000 beneficiaries onto companies that had legally and legitimately left the multi-employer system, and in

¹ Source: Peabody Coal Co., "Why the Coal Industry Retiree Health Benefit Act Should Not Be Amended." (Emphasis supplied.)

² As of March 31, 1995, the Coal Act had imposed liability for retiree health benefit premiums on a total of 257 signatories of NCBWAs prior to 1988 (the "Reachback companies"). Of these, 99 were signatories to the 1978 or later NBCWA, and 158 were signatories only to 1974 or earlier NBCWAs.

³ The temporal extent of the promise to pay benefits has been the subject of considerable confusion as the NBCWA plan documents contain contradictory references to "Health Services card for life" in some places and benefits granted only for "the term of the Agreement" in others.

most cases, the bituminous coal industry altogether, having paid all liabilities for which they were legally responsible.

The only companies that sought to escape their responsibilities under the NBCWAs are the members of the BCOA, who refused to fulfill their express, contractual guarantee of the health benefits of retired miners and their families, and sought relief from Congress when the guarantee clause was enforced against them in court. Unlike the phantom responsibilities and moral obligations the BCOA seeks to pin on former signatories of the NBCWAs who have long since left the bituminous coal industry, the BCOA's commitments to the retired miners were legally enforceable and were in fact legally enforced by the courts, until the BCOA succeeded in enacting the Coal Act to vititate their previous contractual commitments.

A. Former Signatories Have No Obligation to Provide or Pay For Benefits After the Expiration of the Wage Agreement

The BCOA and other supporters of the Coal Act have suggested that former signatories promised lifetime benefits to their employees and dependents and have somehow sought to avoid that responsibility now. To the extent that they identify any source at all, they claim that responsibility derives from several clauses in the 1978 and later NBCWAs and the plan documents. Each is analyzed below.

1. The Former Signatories Made No Promise of Lifetime Health Benefits

Proponents of the Coal Act have asserted that former signatories promised their employees lifetime benefits. That simply is not true. The only references to lifetime benefits in the Wage Agreements, first inserted in 1974, are found in a "General Description of the Health and Retirement Benefits," included in Article XX of the NBCWA. Several provisions state that a pensioner fitting in one of several categories will be entitled to retain his Health Services card for life. Upon his death, his widow will retain a Health Services card until her death or remarriage." Of course, this language at most indicates participation in the health benefits program, but does not require any particular level of benefits. Equally clearly, it imposes no obligation on individual companies. Any promise made is simply that of the coal producers as a whole to ensure pensioners' participation in the health benefits program.

The contractual obligation of any particular employer to provide benefits, however, is clearly limited to the life of the Wage Agreement. Article XX, § (c)(3)(i) states that the benefits provided by the single-employer benefit plans "shall be guaranteed during the term of this Agreement by each Employer at levels set forth in such plans." (Emphasis supplied.) A separate provision — the guarantee clause, discussed in more detail below — similarly provides that the signatory employers guarantee the level of benefits paid by both the UMWA plans and the single-employer plans only "during the term of this Agreement." Art. XX, § (h) (emphasis supplied). Similarly, the General Description expressly states that each employer guarantees benefits at the level of those provided by the UMWA plans only "during the term of this Agreement." (Emphasis supplied).

These provisions demonstrate that the parties were bound by the Wage Agreement only as long as they were effective signatories to it. Indeed, the courts have uniformly so held. Based on these contractual provisions, "it uniformly has been held that an employer is not legally responsible for the provision of retiree health benefits after the expiration of a wage agreement." In re Chateaugay Corp., 945 F.2d 1205, 1210 (2d Cir. 1991), cert. denied, 112 S.Ct. 1167 (1992) (emphasis supplied) (citing District 29, UMWA v. Royal Coal Co., 768 F.2d 588, 592 (4th Cir. 1985); District 29, UMWA v. United Mine Workers Benefit Plan & Trust, 826 F.2d 280, 282-83 (4th Cir. 1987), cert. denied, 485 U.S. 935 (1988); UMWA by Rabbit v. Nobel, 720 F.Supp. 1169, 1176-78 (W.D. Pa. 1989), affd, 902 F.2d 1558 (3d Cir. 1990), cert. denied, 111 S.Ct. 1102 (1991); Schifano v. UMWA 1974

⁴ See Doe v. Connors, 796 F.Supp. 21 (W.D. Va. 1985); UMWA 1950 Benefit Plan & Trust et al. v. Bituminous Coal Operators' Ass'n, 898 F.2d 177 (D.C. Cir. 1990).

Benefit Plan & Trust, 655 F.Supp. 200 (N.D. W.Va. 1987)). See also Box v. Coalite, 643 F.Supp. 709 (N.D. Ala. 1986). Indeed, the Wage Agreements contain "no intimation that the parties intended [a former signatory's] obligation to continue beyond the life of the Wage Agreement." In re Chateaugay Corp., 945 F.2d at 1208.

Because former signatories are not bound by expired Wage Agreements, they cannot be required to provide the benefits established under them. The courts have nevertheless accepted the proposition that the Wage Agreements do promise lifetime benefits to retired miners. The entity on which that promise is binding, however, is the 1974 UMWA Benefit Plan, supported by the contributions from current signatories as required by the Wage Agreement. "Without exception," the courts have interpreted the Wage Agreements and plan documents to impose the obligation, after expiration of the Wage Agreement, upon the 1974 UMWA Benefit Plan, rather than upon the former signatory company, to pay the promised "lifetime" retiree health benefits. Nobel, 720 F.Supp. at 1179-80.5 The courts placed liability on the 1974 Benefit Plan rather than the former signatories because "Iffrom its beginning this trust was intended as the safety net for 'orphaned' retired miners." District 29, UMWA, 826 F.2d at 283 (emphasis supplied).

The most recent decision on this issue also took note of the fact that the parties to the NBCWA made no changes to the relevant portions of the NBCWA after these cases were decided. The readoption in the 1988 agreement of the same language therefore serves to "confirm[] that the judicial interpretations correctly represented the intent of the parties." Nobel, 720 F.Supp. at 1180.

 The Guarantee Clause Places the Responsibility on Current Rather than Former Signatories to Ensure Adequate Funding for Current Health Benefits

Much is made by supporters of the Coal Act that the coal companies guaranteed the payment of benefits, which, they suggest, means that former signatories are continually liable. Examination of the guarantee clause demonstrates, however, that it is binding on individual employers only during the life of the Wage Agreement they signed.

The guarantee clause, Art. XX, § (h), first inserted in the 1978 NBCWA, provides:

Notwithstanding any other provisions of this Agreement the Employers hereby agree to fully guarantee the pension and health benefits provided by the 1950 Pension Fund, the 1950 Benefit Fund, the 1974 Pension Fund, the 1974 Benefit Fund and all other benefit plans described in Section (c) of this Article XX during the term of this Agreement. [Emphasis supplied.]

Moreover, the clause went on to explain that the guarantee would be satisfied by increased contributions, if necessary, that 'shall be made by all Employers signatory hereto during the term of this Agreement." (Emphasis supplied.) Clearly, this provision not only imposes no perpetual obligation on former signatories, but in fact affirmatively limits their obligations to contribute to the plans.

The multi-employer system, reinforced by the guarantee of benefits by the current signatories, was the result of vigorous collective bargaining. The courts have, at the instance of the Trustees, specifically enforced the guarantee clause against current signatories. In several cases brought against the BCOA, courts granted injunctions requiring the signatories to increase their contributions to make up a shortfall in the

⁵ To be sure, during the life of a particular agreement the 1974 Benefit Plan is to provide benefits only for beneficiaries of signatory employers that are "no longer in business." See 1978 NBCWA, Art. XX, § (c)(3)(iii). That provision thus defines the respective obligations of the Fund and the employer during the life of the agreement. See Nobel, 720 F.Supp. at 1179. After the agreement has expired, however, it imposes no legal obligation on the employer. See id.; District 29, UMWA, 826 F.2d at 283. Thus, it is irrelevant whether the former signatories are still "in business" or not.

UMWA funds, as required by the Wage Agreement. See McGlothlin v. Connors, 142 F.R.D. 626 (W.D. Va. 1992); Doe v. Connors, 796 F.Supp. 21 (W.D. Va. 1985); see also UMWA 1950 Benefit Plan & Trust et al. v. Bituminous Coal Operators' Ass'n, 898 F.2d 177 (D.C. Cir. 1990). In contrast, as discussed above the courts have repeatedly rebuffed the Trustees' attempt to force the Reachback companies to provide benefits for 'their' retirees beyond the life of the Wage Agreements they signed. Thus the benefits system established by the collective bargaining process wound up in difficulty only when the BCOA, after drastically cutting its contributions in the 1988 NBCWA over the UMWA's objection, fefused to increase the contributions to the needed level, as required by the guarantee clause in the 1988 NBCWA.

3. The So-Called "Evergreen Clause" Imposed No Perpetual Obligation to Contribute on Former Signatories

Most recently, the BCOA and the UMWA have sought to pin liability on former signatories through the so-called "evergreen clause," which was inserted in the pension and benefit plan documents shortly after the 1978 NBCWA was signed and ratified. Neither the language of the clause, past practice or other indicia of the intentions of the parties support the novel idea that the clause imposes any perpetual obligation. Even if it did, however, the obligation imposed would by its terms merely require contributions based on bituminous coal production, and so the clause, even if it is "evergreen," would unlike the Coal Act -- require no contribution from the overwhelming majority of Reachback companies which no longer mine bituminous coal.

The "evergreen clause" is found not in the Wage Agreements but in the pension and benefit plan documents. When the clause was added to the pension and benefit trusts in 1978, it was perceived as doing nothing to change the traditional allocation of responsibility for retiree benefits, under which signatory companies to the NBCWA jointly shared the current costs of providing health benefits to retirees and their dependents. The clause merely required employers whose employees participated in the pension or benefit plans to comply with the terms of the trusts, including "making the contributions required under the National Bituminous Coal Wage Agreement of 1978 [or the current NBCWA⁷], as amended from time to time, and any successor agreements thereto."

Because the clause merely refers to the "contributions required under" the NBCWA, it of course imposes no independent obligation to contribute beyond that set forth in the relevant section of the NBCWA. Section (d) of Article XX of the NBCWA specifies signatory employers' obligations to contribute. It contains several key limitations that are squarely contrary to any theory of "evergreen" or perpetual liability. First, Section (d) specifically requires contributions only by "each signatory Employer." (Emphasis supplied.) It makes no reference to former signatories. Second, by its terms the contribution requirement applies only "[d]uring the life of this Agreement." NBCWA Article XX, § (d)(1) (emphasis supplied). Third, the Wage Agreement later describes the contribution requirement in similar terms: "This obligation of each Employer signatory hereto, which is several and not joint, to so pay such sums shall be a direct and continuing obligation of said Employer during the life of this Agreement." Id., § (d)(7) (emphasis supplied). The Wage Agreement contains not the slightest hint that any of these obligations continued after the life of the agreement.

⁶ Although the UMWA recognized at the time that the specified contributions would be inadequate, it agreed to the reduced level only because it anticipated that the guarantee clause would assure the necessary level of funding.

⁷ The precise wording varied slightly among the various trust documents, and reflected revisions from time to time to refer explicitly to the current NBCWA. agreement.

⁸ Certain contributions were required for a shorter period of time, see, e.g., Section(d)(1)(i) - (iv), but none extended beyond the NBCWA's termination date, specified in Article XXIX.

Moreover, the Wage Agreement's termination clause clearly indicates that the contribution obligation does not survive the expiration of the agreement. Article XXIX, governing termination of the Wage Agreement, makes a specific exception — but only one — for the continuation of health benefits. The termination clause specifies that in the event of an economic strike, employers must continue benefits for 30 days, after which time they must be paid for by the employees. See Art. XXIX. It is inconceivable that the termination provision would not also make an exception for former signatories who must still contribute to the benefit plans, if there were such an obligation. Instead, the "strike" provision states only that "[t]his paragraph shall survive the termination of the remainder of this Agreement and shall continue in effect until the purpose for which it was established is satisfied." (Emphasis supplied.)

In addition, the most reliable extrinsic evidence of the parties' intentions -- their conduct for most of the time since the birth of the "evergreen clause" in 1978 demonstrates that no one understood the "evergreen clause" or any part of the NBCWA itself to impose a perpetual obligation beyond the particular NBCWA to which an employer was signatory. In 1981, the Trustees of the UMWA benefit plans ruled that an employer's contribution obligation ends when it ceases to be a signatory to the NBCWA. Indeed, the Trustees refused to accept any contributions from employers until they submitted proof that they had signed the current NBCWA or a "me-too" agreement that adopted its terms. Absent such proof, the Trustees returned all contributions for any period after the previous NBCWA had expired. If those companies continued to be liable for contributions based solely on the evergreen clause, refusing to accept the money would have been a blatant breach of the Trustees' fiduciary duty to retirees and their dependents. In fact, however, the Trustees correctly determined that the contributions were not required by the Wage Agreement or the benefit trust documents. Only much later, amid greater labor strife over health and pension benefits, did the Trustees formulate their novel evergreen theory, as a way to broaden their contribution hase.9

Because former signatories' obligations expired with expiration of the Wage Agreement to which they had been a signatory, no contributions would be required of them under succeeding Wage Agreements, regardless of the meaning of the "evergreen clause."

Even if the "evergreen clause" did impose an obligation to contribute to the funds in perpetuity, the Coal Act went far beyond that obligation by transforming a production-based contribution supporting a multi-employer system into one based on assignment of former employees to individual former employers. Under every NBCWA, contributions to the pension and benefit funds were based on bituminous coal production, measured either in tons produced or hours worked in production and related activities. There was no minimum or fixed contribution. As the federal government explained in a brief filed

⁹ The only decision upholding "evergreen" liability, UMWA 1974 Pension v. Pittston Company, 782 F. Supp. 658 (D.D.C. 1992), affd, 984 F. 2d 469 (D.C. Cir. 1993), did so against three companies still engaged in bituminous coal mining. Due to anomalous procedural circumstances in that case, the court initially decided it on cross motions for summary judgment with "virtually no evidence" from the defendants as to the meaning of the evergreen clause. Thus, for example, the court did not have before it the letters and policy statements showing the Trustees' longstanding practice of refusing to accept, let alone require, contributions from former signatories. The court also lacked affidavits which have now been submitted to it from the members of the BCOA Executive Committee, who reviewed and approved the terms of the 1978 NBCWA, which state that they never discussed, much less agreed to, an "evergreen" clause or any other perpetual obligation to contribute. This new evidence has now been submitted to the same district court in a number of subsequent "evergreen" liability cases consolidated before it. It is very questionable that the court can or will impose "evergreen" liability in these cases in the presence of a much more complete factual record on the history of the clause itself. In any event, all of the pending "evergreen" cases including the Pittston case have been referred by the court to mediation before a senior district judge.

against various former bituminous coal producers who were challenging the Coal Act Reachback:

The evergreen clauses did not create any obligation to contribute for companies—such as plaintiffs—that left the coal mining industry because the Wage Agreements generally required contributions to the benefit plans on a per-ton-of-coal-mined and coal-miner-hours-worked basis. Any party who had ceased coal mining operations, such as plaintiffs, thus would no longer be obligated to make contributions.

Brief for the Secretary of Health and Human Services at 6-7, n.*, LTV Steel Co. v. Shalala (In re Chateaugay Corp.), F.3d (2nd Cir. 1995) (No. 94-6024) (citations omitted). Thus, if the Coal Act merely applied the NBCWA contribution formula to all past signatories, virtually none would owe any contributions. Unfortunately, the Coal Act retroactively extended benefits liability to hundreds of companies that had left the bituminous coal industry.

B. The 1992 Coal Act Dramatically Rewrote the Obligations of Former Signatories, to the Direct Benefit of the BCOA Companies

As the preceding discussion makes clear, the Coal Act retroactively imposed obligations on the Reachback companies to finance the health benefits of tens of thousands of retired miners and their dependents. The contracts those former signatories had agreed to afforded no basis for the sweeping liability the Coal Act imposed.

As noted above, due to the unique nature of the coal industry retiree benefits were traditionally provided under a multi-employer system. As the federal court of appeals explained:

The continual discovery of new coal mines and exhaustion of old ones leads to a very high turnover of employers in the coal industry. Because of this and the mobility of employees, labor and management in the industry have since 1950 worked out a means for assuring worker retirement benefits without linking specific workers to specific employers. They have done this through national, multi-employer agreements between the [UMWA] and a multi-employer association of coal producers, [the BCOA]. All coal companies that join the agreements pay into the same health and benefit funds at a specified rate per ton of coal produced, and all eligible employees receive benefits from those funds without reference to the employers they happen to be working for at the time of their retirement.

Connors v. Link Coal Co., 970 F.2d 902, 903 (D.C. Cir. 1992) (emphasis supplied). In 1978, at the behest of the BCOA, the industry prospectively converted to a single-employer-plan system. Post-1975 retirees would be covered by benefit plans established by individual employers. The pre-1976 retirees, however, remained on the multi-employer system under the 1950 Benefit Plan. Even after 1978, therefore, the pre-1976 retirees were not assigned to any particular employer.

In fiscal year 1992, the beneficiaries under the 1950 Benefit Plan, who were the collective responsibility solely of the companies that had joined the 1988 Wage Agreement, comprised more than 85% of the total beneficiaries of the UMWA plans

¹⁰ The Trustees of the UMWA funds do not appear to dispute this position. They have pressed evergreen claims only against companies that still mine bituminous coal, such as Pittston and Massey.

Notwithstanding the BCOA's current posturing as protector of "orphan" retirees' benefits, in 1978 the BCOA wanted to rely exclusively on such plans for post-1975 retirees and leave "orphan" retirees entirely unprotected. The UMWA wisely insisted, however, that the 1974 Benefit Plan be retained to cover retirees of companies that left the bituminous coal business.

and accounted for 86% of the health benefit expenses. According to the June 22, 1995, Committee Print on the Coal Act, for fiscal 1992 the 1950 Fund had 97,599 beneficiaries and expenses of \$208.8 million, whereas the 1974 Fund had 16,021 beneficiaries and \$33.3 million in expenses. Because the beneficiaries of the 1950 Benefit Plan were not attributable to any particular employer, there could be no claim that any former signatory had "dumped" them on the 1950 Benefit Plan. Rather, they were, under the collective bargaining agreements since 1950, understood to be the responsibility of current signatories — until, that is, the Coal Act arbitrarily assigned tens of thousands of them to the Reachback companies.

With respect to those beneficiaries, Reachback companies that signed the 1978 or later NBCWA are in no different position than companies that did not. As demonstrated above, nothing in any of the NBCWAs or plan documents assigned any responsibility to individual employers for those beneficiaries. Their only obligation was to contribute the necessary amount to fund the benefits during the life of the Wage Agreement or Agreements that they had signed. Once they ceased to be signatory, their obligations came to an end.

Only with respect to the post-1975 retirees and their dependents is there any argument that the beneficiaries are attributable to specific employers, based on the switch to a single-employer system in 1978. Yet even in that case, as demonstrated above, the former employers had no legal obligation after termination of the last Wage Agreement they had signed. The collective bargaining process had created the 1974 Benefit Fund as a multi-employer plan specifically to ensure that orphaned miners did not lose their benefits. The Coal Act, of course, changed that entirely by placing liability for those beneficiaries back on the Reachback companies.

The relatively small proportion of beneficiaries of the 1974 Benefit Fund also demonstrates that the problem beneficiaries being "dumped" on the 1974 plan, to the extent there was any problem at all, could have been easily resolved – and in fact was—through collective bargaining without any need for legislation. By the time of the Coal Act, the BCOA and the UMWA had adopted the 1988 NBCWA, which for the first time imposed withdrawal liability for health benefits on companies that sought to withdraw from the NBCWA system. See Art. XX, § (i). That provision would eliminate any concern that the 1974 Benefit Plan would be placed in a disadvantageous position through some companies' departure from the bituminous coal industry and therefore the multi-employer system.

Reflecting the BCOA's confidence that the problem had been solved, at the same time that the withdrawal provision was adopted, the BCOA again voluntarily agreed to guarantee the specified health benefits, including those for the relatively few post-1975 retirees and dependents attributable to companies that had not signed the 1988 NBCWA. Of course, this contractual resolution of the withdrawal liability issue did not deter the BCOA from seeking millions of dollars in additional savings through retroactive imposition of the single-employer assignment and funding mechanism mandated by the Coal Act.

The most prevalent myth surrounding the 1992 Coal Act is that it did little more than hold former signatories of the national coal wage agreements to promises they made in the past. In fact, all of the Reachback companies complied with every contractual obligation with respect to health benefits when they chose not to sign further coal wage agreements. The Coal Act, however, dramatically rewrote those agreements retroactively to transfer the responsibility for tens of thousands of retirees from the current signatories to the NBCWA, especially the largest companies mining bituminous coal today, such as Peabody, Consolidation, and Cyprus Amax, to the Reachback companies. No act has shown less respect for freedom of contract and the collective bargaining process. These circumstances provide a compelling case for the complete repeal of the Reachback provisions of the 1992 Coal Act. At the very least, to the extent that a surplus exists in the Combined Fund, the Reachback companies should, as H.R. 1370 provides, be released from the legislative mandate of the Coal Act to subsidize the BCOA.

STATEMENT OF DAVID JAMISON PRESIDENT OF UNITY REAL ESTATE CO

My name is David Jamison. I am President of Unity Real Estate Company ("Unity"). Unity is a small Pennsylvania corporation that leases office space in a small building and operates a parking lot, both of which it owns. Unity employs two people: an officer (me) and a janitor.

In the Fall of 1993, the UMWA Combined Benefit Fund notified Unity that it was obligated to pay certain annual premiums as a consequence of the newly enacted Coal Industry Retiree Health Benefit Act of 1992 ("Coal Act"). The total premium, \$266,839.92, was to be paid in twelve monthly installments of \$22,236.66 each, with any delinquency subjecting Unity to penalty of over \$7,000.00 per day.

Unity could not possibly pay this astounding new liability. Unity's average annual gross revenue is only approximately \$55,000.00 per year. As a going concern, Unity's value would not exceed \$85,000.00. Thus, Unity did not have sufficient cash to pay the initial \$22,000.00 payment.

If it is enforced, the Coal Act will bankrupt Unity. There is no way Unity can pay the amounts assessed against it, and the Coal Act, as presently structured, permits no exception, even where, as here, it will destroy a Company.

This impact is particularly egregious given that Unity never engaged in the mining business, and the liability is premised solely on its affiliation with entities that legitimately ended their involvement in the mining industry decades ago.

Unity has two connections with the coal industry. In 1969, Unity merged with three inactive coal companies, one of which was South Union Coal Company, a Pennsylvania corporation incorporated in 1922 ("South Union-PA"). South Union-PA had operated coal mines in Pennsylvania between 1922 and 1940; and in West Virginia from 1943 to 1960. By 1961, however, all such operations were permanently terminated. Unity's only other contact with the coal industry was that in 1974, it incorporated a wholly owned subsidiary in West Virginia, also named South Union Coal Company ("South Union-WV"), to operate the mine formerly operated by South Union-PA. South Union-WV operated the mine until it filed for bankruptcy on June 26, 1981.

South Union-PA and South Union-WV were signatory to various National Bituminous Coal Wage Agreements while they were in operation. Ultimately, however, the Bankruptcy Court authorized South Union-WV to reject the last Agreement it signed (the 1981 Agreement) as of its effective date, approved an unrelated third-party's assumption of all of South Union-WV's assets and obligations.

Having had no contact with the coal industry since 1981, I was shocked to discover that the Coal Act, which was passed in 1992, required Unity to pay any amounts at all, let alone more than five times its annual gross revenue. Fortunately, the United States District Court for the Western District of Pennsylvania believes that the Coal Act is unconstitutional as applied to Unity, and issued a preliminary injunction restraining its enforcement.

Separate and apart from the legal arguments set forth in that decision, simple principles of fairness, equity, and justice demand some modification of the Coal Act by which Unity is relieved of these unbearable obligations. Even though entities that were affiliated with Unity formerly employed some UMWA miners that are continuing to receive health benefits, the undisputable fact of the matter is that the provision of such health benefits always has been, and still should be, part of the consideration for which a coal industry employer receives productive work from his employees. In that context, the cost of such health benefits reasonably can be passed on to the employer's customers, or otherwise accounted for in the trade-offs that go along with collective bargaining.

Unfortunately, Unity has no such options for dealing with these Coal Act obligations. Even assuming Unity could pay the initial payment, it could not pass these costs on to anyone else. Unity's office tenants and parking lot customers cannot reasonably be charged the exorbitant rates which would be required to pay for these Coal Act obligations. Likewise, Unity cannot reasonably reduce the wages and benefits of its two employees so as to enable it to pay these Coal Act obligations. Instead, the only option the Coal Act leaves Unity is to file for bankruptcy.

Fortunately, the District Court for the Western District of Pennsylvania has seen fit to prevent this from occurring. Hopefully, you too will recognize the injustice that is being done and modify the Coal Act in some way so as to allow Unity to remain a viable entity.

TAXPAYER COMPLIANCE MEASUREMENT PROGRAM

HEARING

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT

OF THE

COMMITTEE ON WAYS AND MEANS HOUSE OF REPRESENTATIVES

ONE HUNDRED FOURTH CONGRESS

FIRST SESSION

JULY 18, 1995

Serial 104-30

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TAXPAYER COMPLIANCE MEASUREMENT PROGRAM

TUESDAY, JULY 18, 1995

House of Representatives, Committee on Ways and Means, Subcommittee on Oversight, Washington, D.C.

The subcommittee met, pursuant to notice, at 10 a.m., in room B-318, Rayburn House Office Building, Hon. Nancy L. Johnson (chairman of the subcommittee) presiding.
[The advisory announcing the hearing follows:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

SUBCOMMITTEE ON OVERSIGHT

FOR IMMEDIATE RELEASE July 10, 1995 OV-10 CONTACT: (202) 225-7601

Johnson Announces Oversight Hearing on the Internal Revenue Service's Taxpayer Compliance Measurement Program

Congresswoman Nancy L. Johnson (R-CT), Chairman of the Subcommittee on Oversight of the Committee on Ways and Means, today announced that the Subcommittee will conduct a hearing to examine the Internal Revenue Service's (IRS) plans to implement a study of 1994 income tax returns through its Taxpayer Compliance Measurement Program (TCMP). The hearing will take place on Tuesday, July 18, 1995, in room B-318 of the Rayburn House Office Building, beginning at 10:00 a.m.

This hearing will feature invited witnesses only. In view of the limited time available to hear witnesses, the Subcommittee will not be able to accommodate requests to testify other than from those who are invited. Those persons and organizations not scheduled for an oral appearance are welcome to submit written statements for the record of the hearing.

BACKGROUND:

Sound tax policy and administrative decisions depend on comprehensive, reliable, and timely information on the level of taxpayer compliance with existing tax laws. For 30 years, the TCMP has been the IRS's primary program for gathering such information. The IRS collects TCMP data by auditing a random sample of taxpayers' returns in which every line on the return is examined.

In addition to measuring compliance levels, the data is used for estimating the tax gap (i.e., the difference between the amount of income tax owed and the amount voluntarily paid), developing formulas for objectively selecting returns for audit, allocating the IRS's audit resources, analyzing specific compliance issues, and developing legislative proposals designed to improve taxpayer compliance. Congress and federal and state agencies also use TCMP data for policy analysis, revenue estimating, and research.

Beginning in November, the IRS plans to conduct TCMP audits of approximately 150,000 tax returns filed by individuals, small corporations, partnerships and S corporations for tax year 1994. Compliance characteristics will be analyzed and measured within three groupings of individual taxpayers and within 24 industry categories at both the national and smaller geographic levels.

Some believe that TCMP studies are too costly, too time consuming and too burdensome for the taxpayers involved. The IRS must use extensive resources to audit the tax returns selected for analysis. The length of time it takes to plan, implement, analyze and report on TCMP surveys results in a lack of timeliness in the availability of the information gathered. In addition, the burden placed on taxpayers who are the subject of these special audits is substantial. The need to present documentation on every item on a return is laborious and the necessity of discussing issues the taxpayer did not report or claim can be confusing. For those who hire a professional to assist them, there can be a substantial dollar cost involved. And finally, the audits are seen as unfair for those who have fully complied with the tax laws and would not otherwise be the subject of an audit.

WAYS AND MEANS SUBCOMMITTEE ON OVERSIGHT

SCOPE OF THE HEARING:

The purpose of the hearing is to assess the value of the TCMP program to effective tax administration and policy analysis, and to determine if there are less burdensome alternatives available to the IRS to achieve the program's primary goals. Testimony will be received on the uses of the data, its timeliness, its availability for policy analysis, and relevancy to fundamental tax reform. Testimony will also be gathered on the design, sample size, cost and implementation schedule for the current TCMP survey, as well as the IRS's readiness to meet that schedule. Of particular concern is the burden TCMP audits place on taxpayers and whether taxpayers whose returns are selected for analysis should be compensated for the costs they incur as a result of the audit.

In announcing the hearing, Chairman Johnson described the hearing as especially relevant because Congress has not yet received reports on the findings of overall compliance from the 1985, 1987 and 1988 TCMP surveys. "If this Subcommittee is to conduct effective oversight of the IRS, it must have access to the information that will allow it to evaluate the Service's allocation of its enforcement resources. The Committee on Ways and Means should have the most up-to-date compliance data available as it reviews the effectiveness of current law and proposals for legislative changes."

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Any person or organization wishing to submit a written statement for the printed record of the hearing should submit at least six (6) copies of their statement, with their address and date of hearing noted, by the close of business on Wednesday, August 2, 1995, to Phillip D. Moseley, Chief of Staff, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filling written statements wish to have their statements distributed to the press and interested public at the hearing, they may deliver 200 additional copies for this purpose to the Subcommittee on Oversight office, room 1136 Longworth House Office Building, at least one hour before the hearing begins.

FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the

- All statements and any accompanying exhibits for printing must be typed in single space on legal-tire paper and may not exceed a total
 of 10 pages including attachments.
- Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and may by the Committee.
- A witness appearing at a public hearing, or submitting a statement for the record of a public hearing, or submitting written comments in response to a published request for comments by the Committee, must include on his statement or submission a list of all clients, persons, or oranzizations on whose behalf the witness appears.
- 4. A supplemental shoot must accompany each etalement listing the name, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press and the public during the course of a public bearing may be submitted in other forms.

Note: All Committee advisories and news releases are now available over the Internet at 'GOPHER, HOUSE.GOV' under 'HOUSE COMMITTEE INFORMATION'.

Chairman JOHNSON. Good morning, the hearing will be convened. I welcome you to our hearing on the Taxpayer Compliance

Measurement Program.

For 30 years, TCMP, the Taxpayer Compliance Measurement Program, has been the Internal Revenue Service's primary program for gathering information on taxpayer compliance with existing tax law. The Service has used this information primarily to improve its selection of cases to be audited and on occasion to seek legislation to address specific problems. Tax policy and administration depend on comprehensive, reliable, and timely information on taxpayer compliance with existing tax law.

The IRS is now prepared to initiate a new taxpayer compliance program, the biggest one yet. Its purpose is to gather information, not only for audit selection but for better use of all of its resources, including taxpayer assistance and education. Today we look forward to testimony that will describe the comprehensiveness and re-

liability of the information that will be gathered.

But timeliness is an issue for which this subcommittee finds testimony unnecessary. The TCMP studies have been carried out in 1985 on individual and S corporation returns, and in 1988 on corporations, exempt organizations, delinquent returns, and again on individual returns. Seven years later, this subcommittee has yet to receive reports analyzing these findings.

There has to be some agreement on the timely delivery of information to the Ways and Means Committee so that it may be used by those who legislate tax policy and to the subcommittee so that

it can perform adequate oversight of the IRS.

We would also look forward to hearing comments from the witnesses on the imposition of a requirement that the IRS report to Congress a comprehensive analysis of its findings in a timely manner, and further that the data be made more easily available to independent researchers in order to achieve greater and more inde-

pendent analysis of the data.

TCMP studies have been described by some as too costly, too time consuming, and too burdensome. Certainly, the requirement that taxpayers document every item on their return is burdensome. I have been told that taxpayers are even required to provide their marriage certificates to prove they are married. If the information gathered through the TCMP is necessary to the development of good tax policy and good tax administration, it is appropriate to ask if there are more efficient and less burdensome means of gathering that information.

TCMP audits are costly to taxpayers whether it is the cost of the taxpayer's own time or whether that of a hired tax professional. In addition, the audits seem as unfair for those whose returns show no indication of a need for an audit. We have to ask ourselves, is it fair for government to place a burden and expense on innocent people in order to better identify those who may not be so inno-

cent?

Should taxpayers be compensated for their participation? If so, how would that best be accomplished?

I welcome the witnesses today and thank you for your willingness to testify on these issues. Let us start with Phil Brand, the Chief Compliance Officer of the IRS.

Mr. Brand.

STATEMENT OF PHIL BRAND, CHIEF COMPLIANCE OFFICER, INTERNAL REVENUE SERVICE

Mr. Brand. Madam Chairman and distinguished members of the subcommittee, I appreciate the opportunity to appear before the subcommittee to discuss IRS' Taxpayer Compliance Measurement Program in general; as well as our planned TCMP survey of the 1994 tax returns. I have a written statement I request to be entered into the record which I will now summarize.

Chairman Johnson. Without objection, Mr. Brand.

Mr. Brand. The first TCMP surveys were conducted in 1963 and 1964. One of these first surveys involved the examination of 1963 individual forms 1040 tax returns. Data from this survey was used to develop the sophisticated computerized system to select individual and small corporate returns for examination. This system is still in use today. It is called discriminant function or DIF.

DIF benefits taxpayers by significantly reducing the examinations resulting in no change to the tax liability purported by the taxpayer. In fiscal year 1969, prior to the use of DIF, 46 percent of the examinations that we conducted resulted in no change to the tax reported by the taxpayer. In 1994, only 15 percent of returns selected for examination using DIF resulted in no change to tax re-

turns.

This means that a significant number of taxpayers, who have correctly and accurately filed their returns, are not burdened with examinations.

Over the past 30 years, IRS has conducted 25 TCMP surveys of various types of returns. In all these surveys we have focused on specific segments of the taxpaying population—individuals, corporations, partnerships and S corporations—one segment at a time over a 7- to 8-year time period. These surveys were designed to provide statistically valid data on compliance levels by return type and by reported income and asset level at the national and regional level.

Since the data from these surveys is 7 to 14 years old, the IRS is selecting returns for examination and allocating resources based on data that is not current. New data that is statistically valid by market segment and geographical area is critical to enable us to focus our compliance efforts on the most noncompliant taxpayers.

The plan survey for 1994 tax returns will, for the first time, combine the four major return types-individuals, corporations, partnerships, and S corporations. In addition, for the first time, it will also include foreign-controlled corporations giving us much needed data on FCCs. We will randomly select and examine approximately 153,000 returns.

The 1994 TCMP is an integral part of the IRS' new approach to identify and address noncompliance. This approach involves analyzing data by market segments and geographical area, identifying compliance issues, causes for noncompliance, and recommending solutions to address the noncompliance.

Through analysis of TCMP data by market segment and geographical area, the IRS will use education, outreach, and focused enforcement activities in a way that maximizes our impact. In addition, the data will provide better information on noncompliance that can be corrected through legislation.

The 153,000 sample size represents a filing population of over 123.9 million returns—only about one-tenth of 1 percent of that total filing population. Most of the examination work will occur in fiscal years 1996 and 1997. Thus, we estimate that approximately 23.5 percent of our total revenue agent and tax auditor staffing will be devoted to TCMP examinations. In fiscal year 1997, this will decrease to 16.4 percent with a further decline in fiscal year 1998 to 7 percent of the total revenue agent and tax auditor staffing.

Although this TCMP survey does require a fair amount of examination resources, the GAO has stated that the concern that TCMP is too costly has little merit. The most effective allocation of enforcement resources and additional recommended tax law changes that data from TCMP will provide should generate millions more

in revenue than the cost of the TCMP survey.

TCMP audits carefully review all aspects of the tax return and the extent to which it reflects the taxpayer's true tax situation. However, our examiners do have flexibility as to the depth that this review must take and small dollar amounts are not assessed. Thus, we balance the need for accurate data with the burden this places on the taxpayer.

The IRS has considered alternative ways to capture the data that we need to administer the system, including gathering enforcement data from operational programs, conducting numerous specific studies, and conducting opinion surveys. While these alternatives would provide some measure of compliance, there are a number of

shortcomings to such data.

The alternatives we have investigated and tried have not proven up to the task of supporting accurate, verifiable compliance measures. The IRS uses TCMP data to develop DIF formulas to identify and select returns for examination that have the highest potential for tax change, to identify emerging noncompliance trends, to identify compliance problems which can be corrected through legislative change, to assign resources to areas with the highest noncompli-

ance, and to develop tax gap estimates.

Earlier in my testimony, I shared with this subcommittee the impact that TCMP has had on reducing returns that are examined and result in no change to the reported tax liability. In my written testimony I discuss three examples of how TCMP results have uncovered compliance problems which were addressed through legislative change. These examples involved a problem with the number of dependents being claimed, the overstating of child care credits, and taxpayers not fully reporting their State tax refunds. In all three examples, the legislative changes resulted in substantial additional tax revenues.

TCMP data is also used by other agencies and the executive and legislative branches of government to adjust national income and products accounts, and to estimate potential revenue gains from tax proposals intended or expected to affect noncompliance. In ad-

dition, States use relevant portions of our data files for studies of

compliance with their income tax laws.

In conclusion, our goal is to improve our detection of noncompliance, to more effectively assign our resources to the areas with the highest noncompliance, and to identify compliance problems which can be corrected through legislative change. To achieve this goal, the IRS needs data that is statistically valid within market segments and on a geographical basis. The best method we have identified to date for securing this data is TCMP.

The IRS is on target to implement the upcoming survey on time. I assure you we will meet the challenges of conducting the examinations in a timely manner and with the least possible burden to

taxpayers.

Madam Chairman, this concludes my prepared remarks. I will be happy to answer any questions you or the other members may have.

[The prepared statement follows:]

STATEMENT OF PHIL BRAND CHIEF COMPLIANCE OFFICER INTERNAL REVENUE SERVICE

JULY 18, 1995

Madame Chairman and Distinguished Members of the Subcommittee:

I appreciate the opportunity to appear before this Subcommittee today to discuss IRS' Taxpayer Compliance Measurement Program (TCMP) in general, as well as our planned TCMP survey of 1994 tax returns.

Background

For over 30 years, the IRS has relied upon the information obtained from TCMP to collect the proper amount of tax dollars due and owing. Statistically valid data on compliance behavior enables the IRS to focus its compliance efforts on the most noncompliant taxpayers. TCMP is the primary data source for determining, measuring, and tracking taxpayer compliance levels. Thus, TCMP is one of IRS' most important tools to improve compliance.

To determine compliance levels across a filing population, TCMP selects and examines a randomly selected sample of tax returns. TCMP audits are designed to review all aspects of the return and, thus, to determine whether the return reflects the taxpayer's true tax situation. From these audits, detailed data on taxpayers' reporting behaviors is captured and analyzed. From this data analysis, we can determine the extent to which taxpayers correctly report their federal income tax liability.

The first TCMP surveys were conducted in 1963 and 1964. One of these first surveys involved the examination of 1963 individual (Form 1040) tax returns. Data from this survey was used to develop a sophisticated, computerized system to select individual and small business returns for examination. This system, still in use today, is called Discriminant Function (DIF). DIF has significantly improved our ability to identify and select the returns for audit with the highest potential for change. DIF benefits taxpayers by significantly reducing the number of examinations resulting in no change to the tax liability reported by the taxpayer. In FY 1969 (prior to IRS' use of DIF), 46 percent of the examinations resulted in no change to the tax reported by the taxpayer. In FY 1973 (after implementing DIF), examinations that resulted in no change to the tax return had dropped to 30 percent. In FY 1994, only 19 percent of returns selected for examination using DIF resulted in no change to the tax return. This means that a significant number of taxpayers who have correctly and accurately filed their returns are not burdened with an examination.

Over the past 30 years, the IRS has conducted 25 TCMP surveys of various types of returns. In all of these surveys, we have focused on specific segments of the taxpaying population — individuals, corporations, partnerships, and S corporations — one segment at a time. Four separate surveys of these four types of returns were conducted over a 7-8 year time period. The most recent surveys conducted of each of the types of tax returns and the sample size of each survey follows:

Total Samı	111,000 returns	
Partnerships (Form 1065)	1981 returns	27,000 returns
S Corporations (Form 1120S)	1984 returns	10,000 returns
Corporations (Form 1120)	1987 returns	19,000 returns
Individuals (Form 1040)	1988 returns	55,000 returns

These surveys were designed to provide statistically valid data on compliance levels by return type (Form 1040, 1120, etc.) and by reported income/asset levels at the national and regional level. Since the data from these surveys is 7-14 years old, the IRS is selecting returns for examination and allocating resources based on data that is not current. For this reason, the planned survey of 1994 tax returns is an IRS priority.

Planned Survey of 1994 Tax Returns

The planned survey of 1994 tax returns will, for the first time, combine the four major return types -- individuals, corporations, partnerships, and S corporations. In addition, for the first time, it will also include Foreign Controlled Corporations (FCCs); giving us much needed data on FCCs. We will randomly select and examine approximately 153,000 returns. These returns will be examined over a 30-month period beginning in October 1995 and ending in March 1998. Data analysis from this TCMP will provide better DIF formulas to select 1999 returns for examination.

The 1994 TCMP is an integral part of the IRS' new approach to identifying and addressing noncompliance. This approach involves analyzing data by market segments and geographic area; identifying compliance issues and causes of the noncompliance; and recommending solutions to address the noncompliance. Through analysis of TCMP data by market segment and geographic area, the IRS will use education, outreach and focused enforcement activities in a way that maximizes the impact on noncompliance. In addition, the data will provide better information on noncompliance that can be corrected through legislation.

To implement this new approach, the sample design had to accommodate:

- The need for statistically valid data by market segment and by geographic area.
- The need to trend newly gathered market segment data to past reported income/asset level data.

The planned survey also incorporates different types of returns that had previously been handled in separate surveys. The sample was designed to take into account all of the following factors:

- 6 Return Types (Non-business Individual Returns, Sole Proprietor Individual Returns, Corporate Returns, S Corporate Returns, Partnerships, and Foreign Controlled Corporations);
- 30 Geographic Areas;
- 10 Reported Income Level Categories for Individual Returns:
- 5 Reported Asset Level Categories for Corporate Returns; and
- 27 Market/Industry Groupings.

Considering these factors, the 153,000 sample is only slightly larger than the 111,000 sample size for the previous surveys conducted. The 153,000 sample size represents a filing population of over 123.9 million returns -- only about one-tenth of one percent of the total filing population.

In recent months, to ensure that the planned TCMP audits are of the highest quality, the IRS has improved two of its examination tools — case building and market segment specialization program. Through the use of technology, the IRS has greatly enhanced its capability for case building. To improve the efficiency of our auditors and reduce the time it takes to perform an audit, before an examination is started, we now build a more complete case file, including prior and subsequent year tax return data, copies of related information returns, and copies of currency transaction documents. In the past, due to the limitations of our computer systems, taxpayers were asked to provide copies of the prior and subsequent year returns for the examiner to review. Because the examiner is better equipped and more familiar with the taxpayer's overall tax situation, the taxpayer's time and cost of the examination are minimized.

Also, to the extent possible, TCMP examinations will be assigned to market segment specialists, examiners trained in the unique operating procedures, issues, and applicable tax law specifically related to a particular business, group, industry or profession. The market segment specialists are trained to identify and develop industry specific issues. Also, because the specialists will perform audits of certain groups there will be a high degree of consistency and uniformity in the treatment of issues. Of equal importance, MSSP reduces burden, time and cost on the part of taxpayers as a result of the examiner's increased understanding and knowledge of the taxpayer's business and accounting procedures.

The examination phase of the upcoming survey is 30 months with examinations beginning October 1995 and all examinations to be completed before

April 1998. Since most of the examination work will occur in Fiscal Years 1996 and 1997, our costs will be greater in those fiscal years. In Fiscal Year 1996, we estimate that approximately 23.5 percent of our total revenue agent and tax auditor staffing will be devoted to TCMP examinations. In Fiscal Year 1997, this will decrease to 16.4 percent with a further decline in Fiscal Year 1998 to 7 percent of the total revenue agent and tax auditor staffing.

Although this TCMP survey does require a fair amount of examination resources, GAO has stated that the concern that TCMP is too costly has little merit. The more effective allocation of enforcement resources and additional recommended tax law changes that data from TCMP will provide should generate millions more in revenues than the cost of the TCMP survey.

TCMP audits carefully review all aspects of the tax return and the extent to which it reflects the taxpayer's true tax situation. However, our examiners do have flexibility as to the depth that this review must take. Thus, we balance the need for accurate data with the burden this places on the taxpayer.

The IRS has considered alternative ways to capture the data we need to administer the tax system, including gathering enforcement data from operational programs; conducting numerous, specific studies; and conducting opinion surveys.

While these alternatives would provide some measure of compliance, there are a number of shortcomings to such data. The alternatives we have investigated -- and tried -- have not proven up to the task of supporting accurate, verifiable compliance measures.

Uses of TCMP Data by the IRS

New data that is statistically valid by market segment and geographic area is critical to enabling us to focus our compliance efforts on the most non-compliant taxpayers. With this new information, IRS resources will be applied more effectively and consistently -- geographically, within market segments and by issue.

The IRS uses TCMP data to:

- Develop DIF formulas to identify and select returns for examination that have the highest potential for tax change;
- Identify emerging noncompliance trends;
- Identify compliance problems which can be corrected through legislative change;
- Assign resources to the areas with the highest noncompliance; and
- Develop tax gap estimates.

Earlier in my testimony, I shared with this Subcommittee the impact that TCMP has had with respect to the development of DIF formulas -- a significant reduction in the percentage of returns that are examined and result in no change to the reported tax liability.

Now, I would like to share three examples of how TCMP results have uncovered compliance problems which were addressed through legislative changes. First, through data compiled by TCMP, the IRS identified a problem with the number of dependents being claimed. This discovery resulted in legislation that required a Social Security Number for dependents claimed as exemptions. This legislative change, effective for tax year 1987 returns, resulted in 7 million fewer dependents being claimed in 1987 -- an estimated \$2.9 billion in additional revenue.

Another compliance problem identified using TCMP data was the overstating of the child care credit. Again, legislation was enacted requiring the taxpayer claiming the credit to provide a taxpayer identification number for the child care provider. In tax year 1989 (the effective date for the legislation), 2.7 million fewer taxpayers claimed the credit yielding \$1.2 billion in additional revenues. Also, 252,000 new taxpayers began filing Schedule Cs as child care providers which resulted in \$343 million in additional setf-employment and income taxes.

Finally, by using TCMP data, we discovered that taxpayers were not fully reporting their state tax refunds. Through a legislative change requiring the states to file an information return (Form 1099G) with the taxpayer and the IRS, tax year 1989 returns reported additional income from state refunds resulting in \$144 million in additional tax revenues.

These examples represent the importance of TCMP data to IRS' compliance

activities. We believe that the information from the planned survey will have even far more reaching results in terms of our effectiveness in increasing tax collections through a combination of voluntary payments and IRS collection efforts.

Uses of TCMP Data by Others

TCMP data is also used by other agencies in the Executive and Legislative Branches of government, such as:

- The Bureau of Economic Analysis (BEA) uses tabulations of TCMP data in conjunction with other data to adjust national income and products accounts:
- The Joint Committee on Taxation uses TCMP data to estimate potential revenue gains from tax proposals intended or expected to affect compliance:
- The Department of the Treasury uses TCMP as a tool in developing tax policy proposals and in estimating revenue effects of proposals to improve taxpayer compliance; and
- The GAO uses TCMP data for a variety of studies.

In addition, two states have obtained the relevant portions of our TCMP data files for studies of compliance with their income tax laws.

Conclusion

In conclusion, our goal is to improve our detection of noncompliance; to more effectively assign our resources to the areas with the highest noncompliance; and to identify compliance problems which can be corrected through legislative change. To achieve this goal, the IRS needs data that is statistically valid within market segments and on a geographic basis. The best methodology that we have identified for securing this data is TCMP.

The IRS is on target to implement the upcoming survey on time. I assure you that we will meet the challenge of conducting these examinations in a timely manner with the least possible burden to taxpayers.

Madame Chairman, this concludes my prepared remarks. I would be happy to answer any questions you or other Subcommittee members may have.

Chairman JOHNSON. Thank you, Mr. Brand. Ms. Stathis.

STATEMENT OF JENNIE S. STATHIS, DIRECTOR, TAX POLICY AND ADMINISTRATION ISSUES, GENERAL GOVERNMENT DIVISION, U.S. GENERAL ACCOUNTING OFFICE

Ms. STATHIS. Thank you, Madam Chairman.

We are pleased to be here today, Madam Chairman, and members of the subcommittee. To my left is Ralph Block. He is an Assistant Director in our San Francisco office, who is our person responsible for doing most of our studies of TCMP.

I will summarize my statement and submit it for the record if

I might.

Sound tax policy and administration decisions depend on comprehensive, reliable, and timely information on taxpayer compliance. For about 30 years the Taxpayer Compliance Measurement Program has been IRS' primary program for gathering such information. TCMP is unique. Of all the various methodologies that IRS has, it is the only one that gives a statistically reliable indication of nationwide compliance with the Federal Tax Code.

IRS also uses TCMP data to estimate the tax gap, to identify compliance issues, to develop formulas for objectively selecting returns to audit, and to allocate audit resources. Congress and Federal and State agencies rely on this data for policy analysis, for

revenue estimating, and for research.

In 1991 IRS proposed a much smaller TCMP because of criticisms that it was too costly, too intrusive, and too untimely. We reported in 1993 that the proposed changes would reduce the TCMP's usefulness and that the criticisms did not justify such a major modification.

We concluded that the additional revenues generated because of tax law and administrative changes resulting from TCMP analyses had far exceeded the costs. TCMP audits may be intrusive but they affect relatively few taxpayers and they help many others avoid an IRS audit. While timeliness is of concern, we concluded that IRS could speed up its analysis of TCMP data if, for example, it validated data earlier in the process.

IRS is getting ready to conduct the most comprehensive TCMP ever undertaken. Currently planned to begin in November, it will include about 153,000 returns of individuals, partnerships, S cor-

porations, and small corporations.

In comparison to past surveys, the upcoming TCMP should provide IRS auditors with more information and better tools with which to perform more efficient, more effective audits. IRS hopes to collect data for the first time on the reasons for noncompliance and on the particular tax issues involved.

Some of the steps most critical to the success of this TCMP are scheduled to occur within the next several months. These include testing a computerized data collection system and training the auditors who will do the TCMP audits. If the planned data collection system does not work, IRS has developed a backup system but it has fewer capabilities. Even if the planned system does work, IRS currently does not have enough computers for all of the auditors to use the system. That problem needs to be resolved to make the results more useful for compliance research.

IRS also needs to modify the TCMP data base to make available all of the data that the data collection system can provide and to work on computerizing the audit workpapers so that they will be

more readily available to researchers.

With that, I will conclude my oral statement and be pleased to answer your questions.

[The prepared statement and attachments follow:]

TAXPAYER COMPLIANCE MEASUREMENT PROGRAM

SUMMARY OF STATEMENT OF
JENNIE S. STATHIS
DIRECTOR, TAX POLICY AND ADMINISTRATION ISSUES
GENERAL GOVERNMENT DIVISION
U.S. GENERAL ACCOUNTING OFFICE

Sound tax policy and administration decisions depend on comprehensive, reliable, and timely information on taxpayer compliance. For about 30 years, the Taxpayer Compliance Measurement Program (TCMP) has been the Internal Revenue Service's (IRS) primary program for gathering such information. IRS uses the data for measuring compliance levels, estimating the tax gap (i.e., the difference between the amount of income tax owed and the amount voluntarily paid in a year), identifying compliance issues, developing formulas for objectively selecting returns to audit, and allocating audit resources. Congress and federal and state agencies use TCMP data for policy analysis, revenue estimating, and research purposes.

In 1991, IRS proposed a much smaller TCMP because of criticisms that it was too costly, too intrusive, and too untimely. GAO reported in 1993 that IRS' proposed changes would reduce the TCMP's usefulness and that the criticisms did not justify such a major modification. GAO concluded that the additional revenues generated because of tax law and administrative changes resulting from TCMP analyses have far exceeded the cost. And while TCMP audits may be intrusive, they affect relatively few taxpayers but help many others avoid an IRS audit. While timeliness is of concern, GAO concluded that IRS could speed up its analysis of TCMP data if, for example, it validated data earlier in the process.

IRS is getting ready to conduct the most comprehensive TCMP ever undertaken. Currently planned to begin in November 1995, it will include about 153,000 individual and business taxpayers. In comparison to past TCMP surveys, this one should provide auditors with more information and give them better tools with which to perform more efficient, more effective audits. IRS hopes to collect data for the first time on the reasons for noncompliance and on the specific tax issues involved.

Some of the steps most critical to the success of this TCMP are scheduled to occur within the next several months. These include testing the computerized data collection system and training the auditors. If the planned computerized data collection system does not work, a backup system may be used that has fewer capabilities. However, even if the system does work, IRS does not currently have enough computers for all of its auditors to use it. To make the results most useful for compliance research, IRS also needs to modify the TCMP database to make available all the data the system can provide and computerize the audit workpapers.

Madam Chairman and Members of the Subcommittee:

We are pleased to be here to assist the Subcommittee in its inquiry into the Internal Revenue Service's (IRS) Taxpayer Compliance Measurement Program (TCMP). TCMP is a key component of IRS' overall compliance strategy, providing both baseline compliance measurements and data to help IRS improve its compliance programs. IRS collects TCMP data by performing audits on a random sample of taxpayer returns in which every line of every return is examined.

My statement today covers the importance of the TCMP, our conclusions on criticisms of the TCMP, and features and status of the planned TCMP of 1994 tax returns.

I would like to begin with a brief description of TCMP.

TCMP AND ITS USES

TCMP began in 1962 when IRS recognized the increased importance of measuring compliance with the tax laws. Since then, TCMP audits have covered 11 different types of returns. TCMP audits of individual returns have been the most frequently employed, generally being conducted every 3 years. TCMP audits have also been conducted on the returns of corporations, partnerships, and S-corporations, but less frequently than on those submitted by individuals. It has taken IRS more than 4 1/2 years to complete a TCMP. This time frame covers the planning phase (which occurs before tax returns are filed) to final data analysis, which includes estimating compliance levels and developing formulas for selecting returns to audit in succeeding years.

TCMP is a unique tool in IRS' array of strategies to measure and correct noncompliance. It is the only tool that allows IRS to make statistically reliable estimates of compliance nationwide. TCMP data are also important to non-IRS users in congressional and executive branch agencies and academia for policy formulation, research, and revenue estimation purposes.

IRS uses TCMP data to develop objective, mathematical formulas, which it then uses to score returns for audit selection. In this way, IRS can make more efficient use of its audit resources and avoid burdening compliant taxpayers. For example, in 1968, the year before IRS started using this scoring system, about 43 percent of IRS' audits resulted in no change to an individual's tax liability. By using TCMP-based formulas, IRS has been able to more accurately select tax returns requiring changes, thus reducing the no-change rate to less than 15 percent in 1994.

Also, given TCMP's statistical validity and comprehensiveness, it is useful for identifying compliance trends for specific issues and groups of taxpayers. For example, by analyzing 1979 and 1982

TCMP data, IRS identified a significant compliance problem with the number of dependents claimed on tax returns. IRS reasoned that this problem could be mitigated if dependents' Social Security Numbers were required to be entered on tax returns. The 1986 Tax Reform Act required this entry for most dependents claimed. The Joint Committee on Taxation estimated that this change would generate an additional \$300 million in tax revenues annually. IRS has estimated that, as a result of this requirement, taxpayers claimed 7 million fewer dependents on their 1987 tax returns than they did the year before.

TCMP data also allow IRS to estimate the tax gap and its components. The tax gap is the difference between the amount of taxes owed and the amount of taxes voluntarily paid in a year. TCMP data are used to identify the compliance levels with all types of income and deductions and these are the data from which tax gap estimates are constructed.

TCMP data are also used outside IRS to (1) estimate the revenue impact of proposed legislation; (2) adjust the national income accounts, such as the gross domestic product; and (3) conduct research on tax compliance. We have made extensive use of TCMP data in our own analyses of tax administration issues. For example, we used TCMP to identify problems with the Earned Income Tax Credit and erroneous dependent and filing status claims. (A summary of reports in which we made use of TCMP data can be found in appendix I to this statement.)

CRITICISMS OF TCMP

In 1991, IRS decided that, despite its many benefits, TCMP had to be changed to make it less costly, less intrusive on compliant taxpayers, and more timely in producing results. IRS officials believed that these concerns were significant enough for them to undertake a major effort to redesign TCMP. By September of 1992, IRS officials had proposed cutting the sample size by half-to about 25,000 returns for individual taxpayers. IRS officials also proposed modifying TCMP procedures so that not all tax return lines would be audited. In addition, IRS began developing other programs to replace TCMP data, including proposals to use data from operational audits and non-IRS databases to identify noncompliance.

In an April 1993 report, we noted that while these concerns had some validity and TCMP could probably be improved, our analysis of TCMP cases and IRS' support for its concerns led us to believe that these problems were not as significant as IRS asserted. We reported that TCMP was not too costly because past TCMP

¹Tax Administration: IRS' Plans to Measure Tax Compliance Can Be Improved (GAO/GGD-93-52, April 5, 1993).

results had been used to more efficiently allocate billions of dollars in enforcement resources and to recommend tax law changes that generated millions of dollars of revenue a year. We also noted that the burden was small compared with the benefits derived from the TCMP audits. We pointed out that TCMP audits actually reduced the audit burden on taxpayers not included in TCMP to the extent that the use of TCMP data reduced the number of compliant taxpayers selected for other IRS audits. We also noted that IRS could speed up its analysis of TCMP data if, for example, it validated data earlier in the process.

We concluded that the proposed changes to the size and scope of TCMP would undercut its significant benefits. Moreover, IRS itself recognized the value of TCMP as an important source for objective compliance data. Out of this recognition came a new TCMP covering tax year 1994 returns that is larger than previous surveys and for which audits are slated to begin in late 1995.

1994 TCMP--A COMPREHENSIVE EFFORT

The 1994 TCMP will be the most comprehensive TCMP effort ever undertaken. With a sample of about 153,000 income tax returns, this TCMP is designed to obtain compliance information for individuals, small corporations (i.e., those with assets of \$10 million or less), partnerships, and S corporations.² Previously, IRS had done separate TCMP surveys for each of these entity types.

IRS estimates that the TCMP will cost about \$559 million in direct costs over the next 3 fiscal years (1996-1998)—about 16 percent of IRS' estimated \$3.4 billion examination budget—and about \$1.5 billion in opportunity costs, which are the revenues that will not be realized from conducting regular audits. While the primary purpose of TCMP audits is not to produce revenues, IRS also estimates that the revenue yield from these cases will be about \$685 million. The 153,000 taxpayers that will be audited represent about 1/10 of 1 percent (0.1 percent) of the 125 million individual and business taxpayers covered by this TCMP. Thus, relatively few taxpayers will be burdened by TCMP audits. These audits are scheduled to begin in November 1995 and be concluded by May 1998.

The 1994 TCMP sample will stratify tax returns by market segment. A market segment represents a group of taxpayers with similar characteristics, such as those in manufacturing, regardless of

²An S corporation is one taxed similarly to a partnership. A qualifying corporation may choose to be generally exempt from federal income tax. Its shareholders then include in their income their share of the corporation's separately stated items of income, deduction, loss, and credit.

the type of return they file. IRS plans to stratify the sampled returns into 24 business (including one on foreign controlled corporations) and 3 nonbusiness (individual) market segments. IRS believes that stratifying the sample in this manner will allow it to more effectively use TCMP data for identifying noncompliance trends and selecting cases for audit. To ensure comparability with previous TCMP surveys, the sample can also be analyzed in the groupings used in prior TCMP surveys (i.e., by return type, assets, and income). (Appendix II shows the number of sampled cases and estimated number of taxpayers in each market segment.)

IRS also plans to provide its auditors more information on each sample case than in the past. Auditors are to receive 3 years of tax returns (1994 and the two prior years), third-party information returns, and other taxpayer-specific data. Also, District Office Research and Analysis sites are to provide industry-specific profiles for each market segment in their geographical areas. IRS believes that this additional information will help auditors better plan their audits and reduce taxpayer burden by requesting only those taxpayer records that are needed for the audit. This additional information should also improve the results, and thus the value, of TCMP audits.

Unlike in prior surveys, in the 1994 TCMP auditors will try to identify and record the cause of noncompliance and the related tax issues. Knowing the specific tax issues involved and understanding the reasons for noncompliance will help IRS develop cost-effective ways to improve compliance.

IRS is emphasizing quality audits in this TCMP and is training auditors on how to spot potential noncompliant behavior in specific market segments. IRS has also modified its quality review program to help ensure quality audits. In past TCMP surveys, quality control was left largely to line supervisors. For the 1994 survey, IRS plans to have a three-tier quality control program, in addition to supervisory review. In the first tier, an "in-process" review team will review audit workpapers on a sample basis while the audits are still under way to help ensure that auditors are doing quality audits. For the second tier, audit managers will review each case prior to closure. Finally, IRS' audit quality review group will review a sample of closed cases. In addition, the District Office Research and Analysis sites plan to review data entered onto the TCMP database for input accuracy.

In past TCMP surveys, IRS concentrated primarily on income tax issues. In the 1994 survey, employment taxes will receive more attention. Examiners will be told to refer businesses that appear to be in violation of employment tax regulations to employment tax auditors. Information from these audits will also

be part of the TCMP database. This effort should provide much needed information on employment tax compliance as well as data on the treatment of workers as independent contractors—an issue that has suffered from the lack of statistical data and has been the subject of extensive controversy.

Finally, IRS hopes to improve the data collection process. In past TCMP surveys, auditors manually recorded audit adjustments on a checksheet, which was later transcribed into the TCMP database by district or regional office clerical staff. IRS officials have long had a concern about errors that occurred during this data entry process and were not detected until long after the audits were complete. In the 1994 TCMP, for the first time, all case data will be entered directly into computers. To help ensure accurate data, IRS plans to have computer software to do consistency checks that will alert the auditor to correct errors while the audit workpapers are still available for reference. Using such computerized input should reduce the potential for transcription errors and improve the quality of the data transmitted to the TCMP database maintained at IRS' Detroit Computing Center.

STATUS OF THE 1994 TCMP

The 1994 TCMP offers IRS an opportunity to obtain information on the compliance characteristics of a broad segment of the taxpaying population. It is important that TCMP proceed on a timely basis because IRS' compliance data are becoming quite old. The longer the interval between TCMP surveys, the less useful is TCMP, given changes in the economy and the tax law. The latest TCMP surveys were made of 1988 individual returns, 1987 small corporation returns, 1984 S corporation returns, and 1981 partnership returns. The 1994 TCMP, however, is not progressing as smoothly as IRS expected.³

IRS has not met some of its key milestones, including testing of the data collection system to be used for gathering data and development of training materials. Consequently, the first audits will be delayed at least one month, to November 1995.

IRS is developing two electronic checksheets or data collection systems for TCMP. The Totally Integrated Examination System (TIES), under development for use in the regular audit program, is being modified to meet TCMP specifications. Because IRS officials are not sure whether TIES will meet the TCMP data requirements, IRS is also

³In December 1994, we issued a status report on the progress IRS was making on planning for TCMP entitled <u>Tax Compliance: Status of the Tax Year 1994 Compliance Measurement Program</u> (GAO/GGD-95-39, Dec. 30, 1994).

developing a backup system specifically for TCMP. IRS had planned to test these systems in June 1995; but at that time neither was ready. IRS now hopes to have these tests completed by August 31, 1995.

-- IRS had planned to have training materials available by March 1995 and to complete training of the auditors by September 1995. As of July 12, 1995, the training materials were not complete. Auditor training is now planned to begin in October 1995, with most auditors trained by the end of November 1995.

It is important to have a fully functional data collection system as soon as possible because other steps in the planning process, such as auditor training and development of TCMP procedures, depend on it. IRS is counting on TIES to work, but is also developing a backup system in case TIES fails. TIES has the capability to do more audit routines better and faster than the backup system. For example, TIES can automatically produce the Revenue Agent Report that taxpayers receive on the results of their audits. TIES also has the capability to perform on-line data validity and consistency checks, helping ensure that TCMP data are accurate. The backup system does not have these capabilities. Therefore, if TIES cannot be used for TCMP, it may take auditors longer to complete each audit; and TCMP data will be more prone to error.

IRS officials are confident that TIES will pass the August tests, but do not have the same level of confidence that TIES can be used for all TCMP audits. They told us that all revenue agents who will conduct audits at a taxpayer's place of business are scheduled to have portable computers that can handle TIES. These agents are scheduled to conduct about 57,000 of the 93,000 Form 1040 TCMP audits. The remaining 36,000 Form 1040 audits are supposed to be done by tax auditors in IRS field offices. However, all tax auditors do not have access to computers that can use TIES.

According to IRS officials, only 29 of the 63 district offices have computers with TIES capability that tax auditors can use. IRS estimates that about 21,000 TCMP returns will have to be audited either by having tax auditors use the backup data collection system or having revenue agents who have adequate computers conduct the audits. Using the backup data collection system could delay audits and adversely affect the quality of the TCMP data. Having revenue agents audit the returns would increase program costs.

⁴IRS estimated that having revenue agents conduct the audits would reduce examination yield by \$394 million over fiscal years 1996 through 1998.

IRS has estimated that it would cost about \$1.7 million to provide the additional 425 computers and related furniture needed to properly equip tax auditors. IRS officials said that funds are not available to make these purchases. IRS has thus encouraged the districts where tax auditors do not have computers with TIES capability to canvas their districts for computers that can be given to tax auditors doing TCMP audits.

We are concerned that the districts may not find enough computers and will therefore use either more costly revenue agents to conduct the audits or have tax auditors use the less efficient backup collection system.

We are also concerned that IRS will not be taking full advantage of all TIES features for TCMP purposes. IRS officials told us that the "other expenses" and the "other income" lines on business returns are often adjusted during audits, sometimes relating to more than one type of expense or income. Using TIES, auditors may assign codes that identify the specific reason and related tax issue for each type of adjustment made to these lines. However, only one adjustment code will be put on the TCMP database at the Detroit Computing Center.

We were told that the TCMP database would have to be modified to accommodate more than one code and that it would be too costly to do so. However, it may be possible to create a subsidiary file that could be attached to the database that would allow additional codes to be captured. IRS may want to consider this option so that these data can be used for compliance research purposes.

Similarly, TIES allows for computerized workpapers, with detailed information on reasons for noncompliance and audit techniques used. However, according to IRS officials, while auditors are required to use the TIES data collection feature, IRS cannot require auditors to use the TIES workpaper feature because the union contract gives auditors the option of generating workpapers by hand. In our 1994 TCMP status report, we suggested that IRS find ways to make workpapers available through electronic media so that the workpapers would be readily available for compliance research.

IRS agreed to explore the feasibility of at least retaining the disks in cases where auditors use computerized workpapers. We are not aware of any action that IRS has taken on this issue. Better, more efficient compliance research could be done if all audit workpapers were computerized and readily accessible to researchers.

In concluding my testimony, I would like to again take this opportunity to indicate our support for TCMP. IRS' 1994 TCMP plans, if effectively implemented, should go a long way towards improving its collection of compliance data. Better data provide the foundation for better compliance programs as well as the capability to avoid auditing compliant taxpayers. While the start of audits will be delayed at least 1 month, it appears that TCMP audits can still be completed on time. This can only be done, however, if IRS makes a concerted effort to finish development and testing of its data collection system, as well as ensure that all auditors are adequately equipped and trained by the end of 1995.

This concludes my testimony. We will be pleased to answer any questions you may have.

GAO REPORTS THAT USED TCMP DATA

Erroneous Dependent and Filing Status Claims (GAO/GGD-93-60, Mar. 19, 1993)

We found that the dependent support test was too complex and burdensome for many taxpayers to voluntarily comply with; about 73 percent of dependent claims failed to meet the dependent support test. We recommended that Congress consider enacting legislation that would substitute a residency test for the support test and consider eliminating the household maintenance test from the head-of-household filing status. We recommended that IRS correct the problems in its limited matching program and implement a 100-percent computer matching program to identify erroneous dependent claims. We used a sample of 1988 TCMP cases to determine the sources of erroneous dependent and filing status claims.

Many Benefits and Few Costs to Reporting Net Operating Loss Carryover (GAO/GGD-93-131, Sept. 23, 1993)

We found that IRS instructions on the amounts that corporations should report on the net operating loss deduction line were incomplete and confusing. We also found that it was profitable to audit NOLD returns. We recommended that IRS revise its instructions on reporting the deduction to clarify amounts that can be deducted, clearly define net operating loss carryover, require corporations to annually report their carryovers, and use the reported amounts to track corporate deductions of these losses. IRS has implemented our recommendations. We used the 1987 corporate TCMP to identify taxpayers who claimed the NOLD incorrectly.

Computer Matching Could Identify Overstated Business Deductions (GAO/GGD-93-133, August 13, 1993)

Small business tax noncompliance is a serious problem. TCMP audits showed that small corporations in 1987 and sole proprietors in 1988 overstated their deductions by an estimated \$40 billion and did not file required information returns on at least \$19 billion in payments to individual taxpayers. Our analysis of TCMP databases showed reverse matching could have identified overstated deductions and unreported wages. We recommended that IRS do a limited test of a reverse matching program on wages while it addresses the limitations to an expanded program for other deductions, such as for services and bad debts.

Earned Income Tax Credit Design and Administration Could Be Improved (GAO/GGD-93-145, Sept. 24, 1993)

We found that EITC appears to be achieving its goals. Those workers who receive the credit and are below the poverty line have their overall federal tax burden substantially reduced, while those qualified workers who are above the poverty line have their taxes reduced somewhat. Also, work incentives for some workers appear to be enhanced by the credit. However, we also found that one-third of the taxpayers who received the credit were not entitled to it. This occurred primarily because tax filers claimed the wrong filing status. We recommended that IRS modify the tax return to capture all the requisite qualifications information. We used TCMP data to determine the magnitude and types of erroneous EIC claims that IRS' processing procedures could not detect.

IRS Can Better Pursue Noncompliant Sole Proprietors (GAO/GGD-94-175, August 2, 1994)

Sole proprietors account for a disproportionate share of noncompliance. Although only 13 percent of individual taxpayers, they account for an estimated 40 percent of the noncompliance. We found that IRS did not have a comprehensive compliance strategy for sole proprietors. We noted that IRS could better use existing TCMP data to identify root causes of noncompliance. We demonstrated this by using TCMP data to look at the causes of noncompliance for truckers and automobile body repair shops. We recommended that IRS develop pro forma recordkeeping for truckers and ensure that insurance companies provided information returns on payments to automobile repair shops.

Estimates of the Tax Gap for Service Providers (GAO/GGD-95-59, December 28, 1994)

Using the 1988 TCMP and the broadest definition of service provider, we estimated that between 0.2 million and 1.6 million of the 11.5 million service providers may be misclassified employees. The estimate of the 1992 income tax gap for these service providers ranged from \$21 billion to over \$30 billion. If those misclassified workers were reclassified as employees, a significant amount of the taxes owed would likely have been withheld by the employers. IRS studies have indicated that taxpayers subject to withholding were substantially more compliant.

MARKET SEGMENTS AND SAMPLE SIZES FOR IRS' 1994 TCMP

Table II.1: Market Segments and Sample Sizes for IRS' 1994 TCMP--Individuals

				····
	Population	Sample size		
Market segment	of market segment (000)	Form 1040s	All returns	Percent that are 1040s
Nonbusinessno schedules	66,069	5,042	5,042	100.0
Nonbusinessno Schedules C, E, or F	24,647	15,175	15,175	100.0
Nonbusiness with Schedule E	10,250	7,958	7,958	100.0
Very small business	9,785	5,105	5,105	100.0
Farm business	850	6,852	8,602	79.7
Building trade contractors	942	3,135	5,851	53.6
All other construction	226	2,759	6,049	45.6
Manufacturing	201	1,502	6,313	23.8
Mining and minerals	28	1,502	3,457	43.4
Agricultural services	233	1,506	3,067	49.1
Wholesale trade	241	2,167	7,792	27.8
Direct sales to individual	187	1,506	1,595	94.4
Auto and boat dealers and service stations	149	1,504	3,965	37.9
Food and beverage	342	2,841	4,931	57.6
Apparel, furniture, and general merchandise	130	1,506	3,540	42.5
Retailall other	295	1,526	4,268	35.8
Real estate	312	1,506	5,759	26.2

Table II.1: Market Segments and Sample Sizes for IRS' 1994 TCMP--Individuals

		Sample size		
Market segment	Population of market segment (000)	1040s	All returns	Percent that are 1040s
Finance and insurance	246	1,758	4,040	43.5
Air, bus, and taxi	75	1,508	2,805	53.8
Other transportation and utilities	381	1,522	3,703	41.1
Amusement, recreation, and motion pictures	194	1,507	3,671	41.1
Medical and health	444	2,042	5,034	40.6
Business and personal services	509	1,682	6,144	27.4
Hotel, lodging, automotive	813	1,509	5,473	27.6
Unable to classify	57	12,024	15,317	78.5
Miscellaneous business and personal services	532	2,382	2,382	100.0
Miscellaneous services	465	3,159	5,496	57.5
Total*	118,071	92,185	152,534	60.4

[&]quot;Totals may not add due to rounding.

<u>Table II.2:</u> <u>Market Segments and Sample Sizes for IRS' 1994 TCMP--Corporations</u>

		Sample size		
Market segment	Population of market segment (000)	Form 1120s	All returns	Percent that are 1120s
Nonbusinessno schedules	0	0	5,042	0.0
Nonbusinessno Schedules C, E, or F	0	0	15,175	0.0
Nonbusiness with Schedule E	0	0	7,958	0.0
Very small business	0	0	5,105	0.0
Farm business	50	538	8,602	6.3
Building trade contractors	144	1,615	5,851	27.6
All other construction	116	2,175	6,049	36.0
Manufacturing	216	3,662	6,313	58.0
Mining and minerals	25	665	3,457	19.2
Agricultural services	17	444	3,067	14.5
Wholesale trade	213	4,502	7,792	57.8
Direct sales to individual	not available	0	1,595	0
Auto and boat dealers and service stations	74	1,369	3,965	34.5
Food and beverage	129	936	4,931	19.0
Apparel, furniture, and general merchandise	51	917	3,540	25.9
Retailall other	175	1,625	4,268	38.1
Real estate	266	2,967	5,759	51.5

Table II.2: Market Segments and Sample Sizes for IRS' 1994 TCMP--Corporations

	Market	Sample size		
Market segment	segment population (000)	1120s	All returns	Percent that are 1120s
Finance and insurance	103	994	4,040	24.6
Air, bus, and taxi	8	382	2,805	13.6
Other transportation and utilities	76	963	3,703	26.0
Amusement, recreation, and motion pictures	46	963	3,671	26.2
Medical and health	210	1,708	5,034	33.9
Business and personal services	175	3,173	6,144	51.6
Hotel, lodging, automotive	127	2,680	5,473	49.0
Unable to classify	0	2,002	15,317	13.1
Miscellaneous business and personal services	not available	0	2,382	0.0
Miscellaneous services	294	1,080	5,496	19.7
Total*	2,514	35,360	152,534	23.2

"Totals may not add due to rounding.

APPENDIX II APPENDIX II

Table II.3: Market Segments and Sample Sizes for IRS' 1994 TCMP-S-corporations

	Market	Sample size		
Market segment	segment population (000)	Form 1120Ss	All returns	Percent that are 1120Ss
Nonbusinessno schedules	0	0	5,042	0.0
Nonbusinessno Schedules C, E, or F	0	0	15,175	0.0
Nonbusiness with Schedule E	0	0	7,958	0.0
Very small business	0	0	5,105	0.0
Farm business	37	591	8,602	6.9
Building trade contractors	109	598	5,851	10.2
All other construction	80	594	6,049	9.8
Manufacturing	121	595	6,313	9.4
Mining and minerals	17	597	3,457	17.3
Agricultural services	25	596	3,067	19.4
Wholesale trade	111	595	7,792	7.6
Direct sales to individual	not available	0	1,595	0.0
Auto and boat dealers and service stations	46	596	3,965	15.0
Food and beverage	135	597	4,931	12.1
Apparel, furniture, and general merchandise	40	596	3,540	16.8
Retailall other	128	593	4,268	13.9
Real estate	204	594	5,759	10.3

Table II.3: Market Segments and Sample Sizes for IRS' 1994 TCMP--S-corporations

		Sample size		
Market segment	Market segment population (000)	Form 1120Ss	All returns	Percent that are 1120Ss
Finance and insurance	68	598	4,040	14.8
Air, bus, and taxi	11	599	2,805	21.4
Other transportation and utilities	64	594	3,703	16.0
Amusement, recreation, and motion pictures	52	594	3,671	16.2
Medical and health	74	595	5,034	11.8
Business and personal	244	593	6,144	9.7
Hotel, lodging, automotive	78	593	5,473	10.8
Unable to classify	32	595	15,317	3.9
Miscellaneous business and personal services	Not available	0	2,382	0.0
Other miscellaneous services	139	598	5,496	10.9
Total ^a	1,815	12,501	152,534	8.2

"Totals may not add due to rounding.

APPENDIX II APPENDIX II

Table II.4: Market Segments and Sample Sizes for IRS' 1994 TCMP--Partnerships

	V1	Sample size		
Market segment	Market segment population (000)	Form 1065s	All returns	Percent that are 1065s
Nonbusinessno Schedules	0	0	5,042	0.0
Nonbusinessno Schedules C, E, or F	0	0	15,175	0.0
Nonbusiness with Schedule E	0	0	7,958	0.0
Very small business	0	0	5,105	0.0
Farm business	104	621	8,602	7.2
Building trade contractors	31	503	5,851	8.6
All other construction	25	521	6,049	8.6
Manufacturing	24	554	6,313	8.8
Mining and minerals	39	693	3,457	20.0
Agricultural services	21	521	3,067	17.0
Wholesale trade	18	528	7,792	6.8
Direct sales to individual	1	89	1,595	5.6
Auto and boat dealers and service stations	16	496	3,965	12.5
Food and beverage	56	557	4,931	11.3
Apparel, furniture, and general merchandise	23	521	3,540	14.7
Retailall other	56	524	4,268	12.3
Real estate	662	692	5,759	12.0

Source: Final 1994 TCMP Sample Design.

APPENDIX II APPENDIX II

Table II.4: Market Segments and Sample Sizes for IRS' 1994 TCMP-Partnerships

		Sample size		
Market segment	Market segment population (000)	Form 1065s	All returns	Percent that are 1065s
Finance and insurance	134	690	4,040	17.1
Air, bus, and taxi	3	316	2,805	11.3
Other transportation and utilities	23	624	3,703	16.9
Amusement, recreation, and motion pictures	23	607	3,671	16.5
Medical and health	29	689	5,034	13.7
Business and personal services	76	696	6,144	11.3
Hotel, lodging, automotive	58	691	5,473	12.6
Unable to classify	7	696	15,317	4.5
Miscellaneous business and personal services	Not available	0	2,382	0.0
Miscellaneous services	72	659	5,496	12.0
Total*	1,501	12,488	152,534	8.2

[&]quot;Totals may not add due to rounding."

Source: Final 1994 TCMP Sample Design.

(268676)

Chairman Johnson. Thank you, very much.

There are a number of questions that we would like to pursue and the first of them focuses on this issue of whether the IRS is on target in implementing the upcoming survey. The GAO reports that the Service did not meet its June milestone of testing the data collection, nor did it meet its March expectation of having training materials available.

Mr. Brand, would you like to comment? Mr. Brand. Yes, I would, Madam Chairman.

We will have the training materials developed by August 1. The training is scheduled for September and October and we do not anticipate any problems with that. I do not recall the milestone being

earlier, but if it was, it was.

In terms of the data collection and gathering process, we have developed something we call TIES which is our automated system for revenue agents. We have been concerned because of a lack of computers in all of our offices, so we did design a backup system. That backup system is in place and we will be able to gather the data.

So I believe we have met the GAO concerns. We did work with them on the audit. We have been responsive to the audit recommendations and I believe we are on target to commence.

Chairman Johnson. Would you like to comment, Ms. Stathis?

Ms. Stathls. We are hopeful that TIES will work for TCMP because it does online data consistency and validity checks as the

data is being entered.

It also automatically generates the audit report, so the taxpayer will have it immediately at the end of the audit and know what the results are. Because of their automatic generation, the amount of work that the auditors have to put into doing the reports will be reduced. So we are really hopeful that TIES will work for the TCMP and that IRS will not have to use the backup system for any of the audits.

I think this is one of the issues with having enough computers. Having enough will allow TIES to be used for all of the TCMP audits.

Chairman JOHNSON. But is it true that you have not tested your system of collecting this information, and so while you have a backup system, you do not know whether your planned system is even going to work and you have not tested the backup system?

Mr. BRAND. We believe we have tested it sufficiently to know that it will, in fact, work. The issue is, can we get enough computers to some of our front-line employees? We are looking now for re-

direction of computers from other areas.

What we will probably end up with is a mix with our most difficult cases being done by the TIES system. We will use some of the other cases that are not as complex. We may need to use those. But in both instances, again, the data gathered will be the same, it will be loaded in an automated manner, it will be analyzed in an automated manner. The real difference is the generation of the examination reports we will be able to do electronically through TIES. If we do not have TIES, we will have to generate the examination reports manually; that is the difference.

Chairman JOHNSON. But is there not a difference in the ability

of the different systems to collect information?

Mr. BRAND. No. Both systems will gather the same amount of data collected from the TCMP. It is the ease with which you complete the examination and the ease with which you issue the revenue agent's report, that is the difference between the two systems.

Chairman JOHNSON. Are you satisfied that they will be able to

do this?

Ms. Stathis. We are very hopeful that it is going to work.

Chairman JOHNSON. You mentioned, Ms. Stathis, in your comments that the criticism of the surveys has been, in part, that they have not identified the underlying reasons for taxpayer errors. Do you think that this new TCMP effort will do a better job of identify-

ing the reasons for taxpayer noncompliance?

Ms. Stathis. It should. In the past, information on the reasons for noncompliance was not routinely collected in any kind of checksheet fashion. Often the auditor would put a reason in the workpapers but those were not computerized, so you had to do a lot of research and work to find the reasons. This year the auditors are going to be asked to enter codes into the system to record what they think the reason is and to identify the tax issue. The information should be very helpful to Congress as it considers what changes should be made to the Tax Code. You will be able to know which particular issues are giving taxpayers the most problems.

Chairman JOHNSON. Do you think that the degree to which they are pursuing the issue of the status of various employees is ade-

quately addressed in their plans?

Ms. Stathis. IRS is going to be doing some followup work on employment issues and if it is carried out as currently planned, more information on employment issues will be available than was ever available before.

Chairman JOHNSON. One last question and then I will yield to

my colleagues.

One of the things that concerns me about the amount of resources that we are putting into this effort is that it is very big money, and probably the biggest problem in the Tax Code is the underground economy. This seems to be totally irrelevant to the people who do not pay their taxes.

Now, is there any aspect of this program that tries to reach to

that problem of the underground economy?

Mr. Brand. This TCMP program is focusing primarily on the fact that the largest portion of the estimated tax gap is unreported income. Now, we have only estimated the legal sector income. We have tried various different times in the past to estimate the tax gap from the illegal sector. We have never been successful in coming up with a figure as far as legal sector income is concerned.

I would just say, however, that we do estimate that in the legal sector, as far as unreported income, that you are talking approxi-

mately \$62 or \$62.5 billion.

Chairman JOHNSON. That has been discovered in past report studies?

Mr. BRAND. In the past, we used two—I am sorry, Madam Chairman, I may have cut you off. We used two processes to basically estimate the tax gap. It is based on the TCMP but the TCMP data

then is revitalized and brought forward with a series of economic indicators that we get from different places. From these sources, we are able to do an estimate. It is an estimate of the tax gap on those factors.

Chairman JOHNSON. How much unreported income have you ac-

tually found in your last series of this sort?

Mr. Brand. Using the last TCMP audit results for tax year 1992, we have estimated a tax gap for individuals of basically \$62.5 billion from unreported income.

Chairman JOHNSON. What proposals did you make to change the law so that we would better get at that unreported income in the

Mr. Brand. There has been a series of proposals over the years. I can give you three or four examples.

Chairman Johnson, OK.

Mr. Brand. One of the things that we uncovered in a previous TCMP was the fact that, by law, you are required, if you claim a deduction for your State income tax refund in one year, you are required to report any refund in the following year as income.

A recommendation was made and the law was changed requiring information reporting on that. The initial year that was worth \$144 million in additional tax revenue. We also know, through TCMP and other research methodologies, that TCMP statistically confirms areas that we have concerns about but we are not able to statistically confirm it.

In 1986, my recollection is that we asked for legislation, and Treasury asked for legislation that would require the listing of Social Security numbers to claim dependents. Almost 7 million dependents disappeared in the following tax year as a result of that change.

There are a number of instances where, in fact, we felt there may have been noncompliance and we were basically able to statistically prove it through the sampling process. It has resulted in

revenues and tax law changes.

Chairman Johnson. So what I am gathering is you really are deriving information that has to do with compliance, and through noncompliance avoidance of taxes. But you are not finding ways to identify cash transactions that expand the income of many but do not then become reportable and taxable?

Mr. Brand. Our process of examination does require probes for unreported income and that is a major part of the methodology that we use in examinations to verify income reported. The difference is that we do not attempt to use TCMP and we have not been successful with other methodologies to develop tax gap estimates of illegal sector income. We do not estimate the tax gap from

narcotics, prostitution, or activities that are illegal.

Chairman Johnson. I understand that. I am not looking so much at illegal income. I understand the problems with that. I am looking at, in a sense, the whole cash economy that moves without accountability to the Federal Government for taxes due. The kinds of things you are describing to me are enforcement and compliance with existing tax law by taxpayers who are complying in general, but not adequately.

In doing those audits, have you been able to find any ways to get

at other sources of income that are not being reported?

Mr. BRAND. Well, the audit techniques that we do will, in fact, allow us to make various judgments as to additional unreported income. As you go into the examination process, basically when you do the preanalysis of the income tax return, you begin to look at various different reasons that there may be unreported income and there are various different audit techniques that you apply that will, in fact, reveal unreported income.

Then you have to determine-

Chairman JOHNSON. Considering the dimensions of this problem, I do not hear your citing examples of changes in the law that have been made to better reach this income. But this is kind of a tangential issue and I am going to yield to my colleagues so that we can move along.

Mr. Zimmer.

Mr. ZIMMER. Thank you, Madam Chairman.

Mr. Brand, I would like to know some of the practical impact of your program. In a hypothetical situation, if a working couple with two children and a combined income of between \$30,000 and \$50,000 is selected for the TCMP, how long will it take them, on

average, to complete the audit?

Mr. BRAND. That is going to be dependent, of course, on what records they have available and so forth. If you are assuming that they are wage earners, and that their deductions are basically either standard deductions with some dependents or else it is a schedule A that has relatively small amounts of deductions and so forth. An audit like that with the records available should take on average 1½ hours to complete.

It gets more complex, obviously, as you get into other areas.

Mr. ZIMMER. Well, how often are the records not available in your experience?

Mr. BRAND. It depends on the individual taxpayer and their rec-

ordkeeping.

Mr. ZIMMER. Well, we are talking about the average. For instance, I do not know if I could find my marriage license and—

Mr. Brand. I cannot give you that estimate, Mr. Zimmer.

Ms. STATHIS. I do know that from the last TCMP the average amount of time that the IRS auditors spent on an individual's return was 13 hours. But that—

Mr. ZIMMER. Is that with the individual?

Ms. Stathis [continuing]. That is the auditor's entire time, beginning with preparation. The amount of time they would spend

with the taxpayer would be a subset of that.

Mr. BRAND. From a scheduling standpoint for interviews, an examination of a nonbusiness individual return most likely would be done within the office. From a scheduling standpoint, we are normally scheduling four to five examinations a day; three to four in a situation if TCMP is what we are trying to do.

That allows our examiners to complete workpapers, an audit re-

port, and the TCMP checksheet.

Mr. ZIMMER. Now, does the audit take place during normal business hours?

Mr. BRAND. Yes, sir.

Mr. ZIMMER. In the hypothetical situation both the husband and

wife are working; do they both have to attend the audit?

Mr. BRAND. No. They would not have to both attend the audit. They could, depending on what the nature of the situation is, but one or the other is generally fine.

Mr. ZIMMER. What sorts of questions would they be asked?

Mr. Brand. Basically we would ask for verification of income. We would, in fact, go through the tax return on a line-by-line basis in terms of what was reported so we would want to look at the W-2s that reflect the information on the tax return in terms of income. We would look at the 1099 forms. We would compare that, obviously, with the information that we have in the files in those particular areas. We would ask the question, is there other unreported income? We would look at the dependents.

The depth is up to the individual examiner. As you start the audit and, in fact, you start through the first 10 lines—and let us say there are 5 entries on the first 10 lines—you basically begin

to develop a pattern that this is a compliant taxpayer.

Then the examiner has the ability to limit the scope of what they would accept for proof and what they would basically require the taxpayer to provide. It is partially judgment, but we do require them to make an entry, to make a comment on each line item. Because this is, in fact, a research examination as opposed to an examination strictly for tax.

Mr. ZIMMER. But, for example, how frequently would a married

couple be asked for a marriage license?

Mr. BRAND. It would depend in many instances, but we would frequently ask for that. We would ask to prove marital status. One of the things we would want to prove is that there is a marital deduction.

If you have a situation where this was primarily a compliant taxpayer and all the other items were verified, then the judgment of the auditor could, in fact, say, I will accept the proof of what I have got. Part of it is based on oral testimony and other types of proof.

Mr. ZIMMER. Are they given a checklist of things to bring with

them, including their marriage license, before they attend?

Mr. BRAND. As we send the letter out, we inform the taxpayer of the items that are under consideration and since all items are under consideration, we try to ask people to bring in what we think is needed for verification. Bring in some type of verification of marital status.

Mr. ZIMMER. How frequently do they have to come back? For

what percentage of the audits?

Mr. BRAND. Let me provide that for the record. I do not have that with me, but I will be glad to provide that for the record.

Mr. ZIMMER. Does the IRS ask people in these circumstances extraneous questions such as income from nontaxable municipal bonds that do not relate to any line-by-line analysis of the tax return?

Mr. BRAND. We do attempt to get a picture of the taxpayer's financial situation and their economic situation. This goes back to the issue that the chair asked about unreported income, how do you probe for unreported income? So we are looking for indicators

of unreported income to see if, in fact, the tax return is reflective of the individual's financial situation.

But we should not be into an area that is not related to that tax return and is not related to verifying income or assuring that the right amount has been reported.

Mr. ZIMMER. Would the IRS ask about noninterest bearing check-

ing accounts?

Mr. BRAND. We could, yes, sir.

Mr. ZIMMER. About gifts that the taxpayer has received?

Mr. BRAND. The way you would get into discussions in this particular area, Mr. Zimmer, would be if there were indications during the examination that there was income in excess of what had been reported, or there were expenditures in excess of the income that is reported. At that particular point in time, we are trying to determine the source of that additional income. There could be a legitimate source, such as gifts being received or expenditures from gifts, or outlays that might be subject to discussion.

Because what we are trying, again, to determine is the financial picture. Is there a reality as far as the tax return is concerned? Does that tax return represent the financial picture of the tax-

payer?

Mr. ZIMMER. So the only questions that you ask are questions that relate to the validity of that tax return, not to other research objectives or data collection interests that you have?

Mr. Brand. In terms of the research, it is related to the tax re-

turn and the financial issues involving that tax return.

Mr. ZIMMER. Well, let us say that the couple refuses to divulge information about a noninterest bearing checking account, would

you subpoen that information?

Mr. BRAND. It would depend on the extent of what we felt other noncompliance is. IRS has the ability to summons that but again, I do not know what the situations are. But not with a small income-tax payer in a situation like that, depending on what the other circumstances were. If this largely appeared to be a compliant taxpayer, I doubt we would do that, but, yes, sir, it could happen. It depends on the individual situation.

Mr. ZIMMER. But if your interest was only to develop a data base

for your research purposes——

Mr. Brand. Well, again, I think what we may be doing is two things. The TCMP audit is only slightly different than a regular examination. From the standpoint of the Taxpayer Compliance Measurement Program examination, examiners are expected to exercise the same judgment about the level of proof and need for information as in a regular examination.

Mr. ZIMMER [continuing]. So for TCMP, you are only looking at—

might you have a broader scope?

Mr. BRAND. We would only broaden the scope if we felt that there was unreported income on that particular examination. Absent unreported income, there would not be any reason for us to go into it.

Mr. ZIMMER. All right, thank you, very much.

Chairman JOHNSON. Mr. Laughlin.

Mr. LAUGHLIN. Thank you, Madam Chairman.

Ms. Stathis, in your testimony, you state that the additional revenues for the TCMP analysis far exceeded the costs. You gave the example of requiring dependent Social Security numbers to be included and that caused, in 1 year's time, 7 million dependents to be dropped from the claim.

How much revenue did that produce by the dropping of these 7 million dependents, and can you tell us how that related to the cost

of the TCMP?

Ms. Stathis. In our 1993 report, we show that the individual TCMP, the last one that was done, cost \$88 million. The Joint Committee on Taxation had estimated that the dependent SSN change would bring in \$300 million a year. I believe that estimate was before the actual number of 7 million dependents was realized, however. I have seen different estimates on the 7 million, ranging from \$1 billion up to \$3 billion a year. So I am not quite sure what the right number is but I think it is probably the billion dollar figure.

Mr. LAUGHLIN. A billion dollars in additional revenues resulting from this 7 million dependents being dropped from the tax returns?

Ms. STATHIS. That is right.

Mr. LAUGHLIN. Now, what other examples—first before I go there, did those 7 million dependents that were dropped show up as taxpayers somewhere else or did the TCMP indicate what hap-

pened to the 7 million that got dropped?

Ms. Stathis. No, the TCMP was what led to requiring taxpayers to report dependent SSNs. The numbers that were dropped, the 7 million, come from a comparison of the number of dependents who were reported on 1986 tax returns versus the numbers who were reported on 1987 tax returns.

Mr. LAUGHLIN. Can you give us any other examples of changes that resulted in additional revenues? Again, give us the relationship the change caused by way of increased revenues and cost to

the TCMP.

Ms. Stathis. Well, for example, real estate gains are now required to be reported——

Mr. LAUGHLIN. Real estate what?

Ms. STATHIS. Real estate transactions. IRS now gets some form 1099 reporting on real estate transactions because, through TCMP, IRS determined that there was a tax gap in that area approaching \$8 billion. Stock transactions are now reported because that had been found to be about a \$2 billion tax gap issue.

Generally, when additional reporting on a tax return or through a form 1099 information return is required, IRS expects it to increase voluntary compliance and, thus, more of that type of income

will be reported.

Going back to Chairman Johnson's question earlier about unreported income, one of the proposals that the Service offered up a year or so ago was something called SINC. I have forgotten what the acronym stood for but SINC, too, was a proposal to have more information reporting on this type of cash income.

Information reporting generally has proven to increase compli-

ance levels and bring in greater revenues.

Mr. Brand. Mr. Laughlin, if I might, I might be able to give you a couple of more examples if you are interested.

Mr. LAUGHLIN. Yes, sir.

Mr. BRAND. Alimony income was going unreported. That is a \$316 million gain in revenue as a result of requiring information reporting in that area. There were also excessive exemptions for people claiming the additional exemption for being 65 or older. Child care credit was going unreported and being overreported in one instance, and being underreported by the providers of child care. There are a number of examples like that that show billions of dollars of additional revenue.

Mr. LAUGHLIN. You anticipate by doing another TCMP audit that you will uncover other areas where legislation will bring forward

additional revenues?

Mr. Brand. I think the thing to realize about the TCMP is that the primary purpose is to improve the selection process for tax returns. There is the ancillary benefit that we sometimes walk in and find these particular trends. Oftentimes, we confirm the trends statistically that we believe are occurring through our normal examination program, but it provides statistical validity to the problem.

Mr. LAUGHLIN. Ms. Stathis, I have one other area of inquiry and that is that you have stated that the IRS could speed up its analysis of the TCMP data. Did that also include a discovery that the IRS could speed up the time the taxpayer spends going through the audit, and if you could give us some examples of specific recommendations you had in mind when you said they could speed up

their analysis?

Mr. BLOCK. I would like to answer that question. IRS is doing a couple of things in this TCMP audit that should reduce the amount of time auditors have to spend with taxpayers. Before the audit begins, each auditor will be supplied with 3 years' worth of taxpayer information. They will have information return data on taxpayers and a number of other types of taxpayer related information. With this information, the auditors should be able to plan their audits and know exactly what questions they will have for taxpayers.

When they visit taxpayers, they should not have to burden them for copies of data they, the auditors, already have. For example, if the auditor already has a W-2, there is no need to ask the tax-

payer for the same W-2.

We believe IRS will be able to use the data faster under this TCMP because it will all be entered electronically by auditors. Although IRS will not be able to update its audit selection formulas until all of the data is in, IRS can still use the data as it is being entered to look at trends in noncompliance by geographical area. This should help IRS see some potential problems long before the data from all TCMP cases is analyzed, and it then could start to work on those problems.

That is how we believe IRS should be able to reduce taxpayer burden and speed up use of the data. We do not know for certain that IRS will do that, but we have hopes that it will, and we will

be monitoring this process.

Mr. LAUGHLIN. Your response has prompted a second question and that is, you stated the IRS agent will prepare his or her questions for the taxpayer as they come in. It occurred to me that it would also speed up the whole time involved in the audit if the

agent were to give the taxpayer the questions or the areas of inquiry so that they might come prepared rather than feeling like they are going to get sandbagged. I wonder if the IRS or the GAO has given consideration to a decision of having the agent tell the taxpayer what the area of inquiry is going to be?

Mr. BLOCK. Well, the auditors do that in an oblique way when

they ask taxpayers to provide various information.

Mr. LAUGHLIN. Is this preliminary to the taxpayer showing up at the audit?

Mr. BLOCK. Yes.

Ms. STATHIS. The letter they receive informing them of the audit should give them that information.

Mr. LAUGHLIN. The information of the areas of inquiry that the

agent intends to go into?

Ms. Stathis. That is right.

Mr. LAUGHLIN. OK. Thank you, Madam Chairman.

Chairman JOHNSON. Thank you.

Mr. Hancock.

Mr. HANCOCK. Thank you, Madam Chairman.

Ms. Stathis, I notice in your testimony you say that it has taken IRS more than 4½ years to complete a TCMP. I am assuming that because of the changes in the income tax law that you have got something after you complete it. Because you are making an analysis of what the law was at least 4 years ago, is that correct?

Ms. Stathis. That is correct.

Mr. HANCOCK. So you have made an analysis that is already 4 years old?

Ms. Stathis. That is right.

Mr. HANCOCK. So you still do not know. You just know what it

was 4 years ago?

Ms. Stathis. That is right. Timeliness is an issue. It always is, there is always a lag. Not only are there tax law changes, there are other kinds of economic changes.

Mr. HANCOCK. So we know now then that your last compliance report is at least 4 years old, so you do not really know what the compliance is going to be for last year? You only know what it was

in 1990 based on the law in 1990.

Ms. Stathis. Right. Actually some TCMPs are a lot older than that. The last TCMP that was done of partnerships used 1981 tax returns. For S corporations, I believe it was 1984 returns. For small corporations, it was 1987 returns, and for individuals it was 1988 returns.

So the data available right now is very dated.

Mr. HANCOCK. I just want it in the record that this is another indication that we ought to leave the tax law alone for a while until people can figure out what we are doing, because we are already outdated even on your compliance reports. You are spending millions of dollars to make these reports, but by the time you get them completed, it is 5 years old, so you really do not know. You just know what it was 5 years ago. Historical data is all we are talking about.

Ms. Stathis. That is correct. That is why the point Mr. Block was making is important. For the first time, if IRS is able to enter the TCMP data in the computerized system and have it available

on a more real time basis, there is hope that some of it will be more immediately useable. It will not be valid until all of it is put into the computerized system. But, if sufficient amounts of data are put into the system fast enough, some early indications can be obtained. I think that is the real hope with having the computerized data entry system. That is why we think it is very important.

Mr. HANCOCK. In your compliance investigations, Mr. Brand, do you find that where you get into some particular area that the tax preparers are involved from the standpoint of merely giving incor-

rect advice to the income-tax payer?

Mr. BRAND. It is one of the things that we will attempt to determine with this particular TCMP. In response to a question of the chair earlier, Ms. Stathis has referenced that we are looking at the causes of noncompliance as we go through the examination process. That is one of the areas we want to look at.

We do know from our compliance programs that you tend to find more changes in returns where the taxpayers are represented. However, those returns also tend to be more complex and there is more tax planning, so it is hard to read a conclusion. I would not want to draw the conclusion that there is a cause and effect. I suspect you would find it in some instances. It is going to be dependent on the individual practitioners, but I believe the complexity of tax returns also enters into it.

Mr. HANCOCK. Thank you.

Chairman JOHNSON. Mr. Brand, just to follow up briefly, you expressed some concern earlier, as did Ms. Stathis, as to whether or not all of your revenue agents would have adequate computer capability as they move forward in this audit. My understanding is that you need about \$1.7 million to provide the necessary equipment. In the context of a \$550 million program, and considering that the success of the computer aspects of the program will determine the timeliness of the information, are you going to be able to find the \$1.7 million?

Mr. BRAND. Whether we find the \$1.7 million or whether we divert computers from other parts of our operation, we will do this in an automated manner.

Chairman JOHNSON. So you have no question in your mind but that all of the agents participating in this audit program will have good solid computer capability?

Mr. BRAND. We will have the ability to load this data in auto-

mated format and be able to analyze in an automated way.

Chairman Johnson. Given that fact, can you tell us when this

subcommittee could expect a broad outline of your findings?

Mr. Brand. I believe that you have asked—as I recall, there has been some discussion, Madam Chairman—about us providing reports to you on a periodic basis. We will be more than happy to provide reports as we go through the process of TCMP as to its progress and what we find preliminarily as we go through the process.

The thing that I want to say, though, is that what we are driving for is statistical validity so we can use this for the basis of selection of work and for recommended changes. So what we want to make sure is, whatever we provide, we are going to provide with the right cautionary note that it may not be valid at this particular

point in time.

Chairman JOHNSON. At this time, in looking at the plan that you have laid out, would you estimate that we could have a pretty solid report before us in 3 years?

Mr. BRAND. Yes, ma'am.

Chairman Johnson. So we do not have to think in terms of the

5 years of the past?

Mr. Brand. Again, when we talk about the analysis of the report, I think we may be talking about two things. There is the TCMP data itself. I believe the reports you may be referring to are the estimates that we do on the tax gap which is based on TCMP, but then annually refreshed or refreshed when we do reports with other economic data. We can provide those on a timely basis.

Chairman JOHNSON. We certainly will be interested in those, but we will be more interested in the specific conclusions of the TCMP and their policy implications. Ms. Stathis, do you have any concerns about the ability to provide us with a substantial report in

3 years?

Ms. Stathis. Not on the TCMP results. One of the things to keep in mind is that the results of the TCMP are used long before the tax gap studies are released. The TCMP results are going to be used to update the selection formulas for identifying returns to audit in the regular audit program. That has already been done using 1988 TCMP results. In fact, updated formulas were used for 1993 tax returns. There are a variety of other uses made of TCMP data long before the tax gap estimates are released.

Chairman JOHNSON. Is that data from which you can draw policy

implications that would be available earlier than 3 years?

Ms. Stathis. Yes.

Chairman JOHNSON. My understanding is that you will not finish the audits for the first 2 years, it will take them 2 years to go

through this.

Ms. Staths. Well, at the end of 3 years, IRS definitely should have valid data. There will be points along the process when there will be a sufficient sample of particular returns that will be valid earlier than 3 years. Data may not be valid for other types of returns until all results are put into the system, which may take 3 years.

If IRS were to get down to one line item on the return and there were only a certain number of those returns filed, a very large sample would have to be examined in order to obtain valid results. But if the sample was stratified in certain ways, some kind of nationwide sense of compliance problems could be obtained earlier.

We have done a variety of studies for Congress in which we have been asked to study a particular issue. In doing them, IRS has allowed us to use the old TCMP data. So, on a number of our studies, we have gone back in and used the 1988 TCMP workpapers and data in order to analyze—

Chairman JOHNSON. Some of it is very old.

Ms. Stathis. That is true but the point is the data is useable way before IRS issues the tax gap report.

Chairman JOHNSON. Mr. Portman. Mr. PORTMAN. I thank the chair.

I thank you all for being here this morning to bring us up to speed on TCMP. I have a number of questions that were really echoed by some of my colleagues already, but I wanted to focus a little more on them.

The two concerns I have are taxpayer burden and the cost of the program. I do not question the value of the previous TCMPs. I wonder if this one is overbroad, whether it is timely, and whether there

are ways to make it more efficient.

In terms of the cost to the government, I have heard various numbers this morning and there are various numbers in the testimony that I have looked at. I have seen anywhere from \$200 to \$500-plus million. I guess all I can say is unless someone has some comment on that that gives us a more precise number, that is sort of the range that I would be thinking, \$200 to \$500 million in cost to the IRS to conduct this.

Mr. BRAND. Mr. Portman, I think there are a number of ways to look at cost. The fact is that we will have the employees on board and we will be paying the salaries of the employees, whether they are involved in TCMP examinations or other examination work. So to basically look at the staff years, FTEs and moneys applied, there is one way to estimate it.

The way that I prefer to estimate it is the opportunity cost that is lost. We know by working TCMP examinations that we will suffer a decline in the amount of penalty and interest or the amount of tax and penalties that are recommended, because this is a random sample, and by its very nature, a no change rate is high.

I believe a correct way of estimating cost is to look at revenue projections had we not done the TCMP and applied these FTEs in that manner. My recollection is that that is about \$1.5 billion that we would have received from these particular resources. We know the results. We estimate the results of the TCMP to be about half that, so your opportunity costs are really in terms of revenue over the life of this. The cost of the employees, and so forth, are expended by the——

Mr. PORTMAN. Let us focus a little more on that, if we can. I was not planning to get into this area, but you raise an interesting question and that is what the projected savings are over time really to the system through increased compliance and what are the

opportunity costs that would be missed without doing this.

We are talking seriously in this subcommittee and it is a national debate now about fundamental change in the tax system. We are talking about a flat tax, we are talking about a consumption tax. There are various proposals, but all of them are, in essence, replacing the current system with a new one, a radical overhaul of

our existing system.

I would think that the TCMP results might well not be generating that kind of savings over time, if indeed we go ahead with this. I think the projections are based on our current system, which I think is unlikely to survive at least past 1997. I think to go ahead with such a massive undertaking of 153,000 individuals and all of the time and effort that the IRS is going to put into this, where otherwise IRS would be focused on making the current system work better over the short term, is questionable, given where we are in terms of major tax reform.

The second issue I have generally is on the burden on the taxpayer. Now, we can make that less, and I think that is in the interest of all of us. Mr. Brand, as you indicated in your response to Mr. Zimmer, it might take about 1 hour for a person in the \$30,000 to \$50,000 range to respond to the audit. I think that is quite optimis-

tic, from my point of view.

I note that, based on some other testimony I have just read through, that up to 60,000 of these returns may well be business returns. I assume that is S corporations, partnerships, sole proprietors, and so on. I cannot imagine that it is going to take 1 hour. I cannot imagine it is going to take 20 hours. I cannot imagine it is going to take anything less than something like 20 to 100 hours for those kinds of taxpayers to pull this information together and to be responsive to all this information.

I have looked through your indirect methods worksheet that I guess all the agents will have. I have looked through the components of so-called economic reality, including club memberships, including hobbies and toys and weddings, including level of sophistication, cultural background, education and work experience, and so on, alimony—there is a lot of information to be compiled and it is a very intrusive process. I think we ought to be realistic about

it and not talk about taking 1 hour of the taxpayer's time.

Mr. Brand. Mr. Portman, I certainly would not want to have indicated, though I believe that is the time that it would take for most of the nonbusiness individuals involved in the TCMP. That would be a mischaracterization on my part.

Mr. PORTMAN. What would you say the average is?

Mr. Brand. Again, it depends on the type of tax return that is involved-corporate, individual, business, schedule C. We can provide that information for the record and would be more than glad to do that. I think that is an important issue. Again, I would not want to leave this subcommittee with the fact that we do not understand that there is a degree of difficulty that this requires of

taxpayers, especially those involved in the no change.

The key here to remember, one thing I would ask you to remember, as you think about this process, is that it does have long-range implications of fairness, because it does provide us with a basis of selecting tax returns on some methodology that is developed and understood, as opposed to us simply shopping for those who we might think within our experience might be noncompliant. This drives our methodology of scoring the selection of tax returns for examination.

The second point that I would ask you to remember is that with this system in the past, with the development of it, we have been able to drive the no-change rate on millions and millions of other taxpayers down to the point that we have been less intrusive. So

it is a tradeoff, no question about it.

Mr. PORTMAN. I would just make three comments. No. 1, if we are talking about a 3-year or a 4-year life as we had in 1988, I wonder whether it is going to be relevant. No. 2, I think there have got to be ways, Mr. Brand, for us to make this more efficient than what we are seeing here. It is sort of like a huge focus group. With the current technology and the probability statistics of information that we now have available to us. I find it hard to believe we need 153,000 people in this focus group, so I would think there might

be a way to just make it work better, work more efficiently.

Finally, I would say that I think any time we get into these kinds of audits—and I know this is only 153,000 Americans and the benefits could potentially accrue to millions of Americans in terms of less audits in the future—I think we have to look carefully at who is doing these audits, whose word is taken.

You said earlier there will be a lot of discretion with the auditor. Who are these auditors? Are these the junior auditors who often go out on these audits to cut their teeth? Are these people who are

going to have some experience, some background?

I think we need to be very careful about doing this, if we are going to do what I perceive to be perhaps an overly broad approach, to do it in a way that gives the taxpayer the ability to have an appeal process or to come back with information that, although it might not be all the documentation lined up as the IRS agent would like, it is something that the IRS can accept and then move on.

Mr. Brand. One of the things we have done this year to increase quality and to speed up the process is that we have required specific levels of experience before an auditor can be assigned to a TCMP audit. That level of experience obviously will vary dependent

on the complexity of the tax return.

Just one other point, too, in terms of the size of the sample. What the TCMP gives us that we have never had before, with the construct of this TCMP, are really two very important items that we have not had before, from a tax compliance standpoint. The first is for the first time in our history we will have compliance rates by 30 geographical areas across the United States which are analogous to our district operations. We will be able to determine what the compliance rate is within a much tighter geographical area.

Before, everything we did was national in its estimation and national in its scope. We know from the prototype work that we have done, that there is substantial difference in compliance in various

geographic areas, and so that helps us allocate resources.

The second item is that this will give us compliance by market segment. In the past, someone could be involved in retail, either at the corporate level or the individual level or subchapter S, and that all got buried more or less in the same type of situation. What we believe now is that there are different compliance levels, depending on the market segment, whether it is retail, wholesale, mining, or manufacturing. Again, the purpose of the expanded examinations is to give us compliance rates that are both geographically sensitive and also by market segment.

Mr. PORTMAN. I thank you for that.

One final question and then a comment. Has there been thought given to compensating individuals who go through this process, who expend these hours that we will be learning about from the information Mr. Brand is going to provide us? I would think the subcommittee could also benefit from some analysis of what the cost might be to the taxpayer, given the realities. If you are looking to people who have business income, I think it is going to require professional assistance and there will be tremendous cost to that.

But after someone has gone through all of this process, is there any talk about compensating people who in the end are found to have been fully in compliance and have cooperated with the IRS in this effort?

Mr. Brand. Mr. Portman, the discussion has been external. There has not been internal discussion. We have done some estimates based on the fact that we know the issue has been raised and is a question. Really, it is a question more appropriately answered by Treasury, as opposed to IRS, I believe, because I believe

it enters into the realm of tax policy.

Mr. Portman. That is fine. I guess my final comment would be that we would appreciate, certainly I would, any information you have on just the average time you think this will entail based on previous audits. Although I know there have not been audits of this type of looking at the economic realities, and then the cost, the cost to taxpayers, just so we know that up front and we can deal with that issue.

I appreciate your testimony this morning.

Ms. STATHIS. Mr. Portman, it will not make the person who is involved in a TCMP audit feel any better, but if the IRS auditors were not doing a TCMP audit, they would be doing more of other kinds of audits. So, in a way, the burden may not be that different in total. It just is distributed differently and the people who are involved in the TCMP audits are going to bear more of that burden

than they would otherwise.

Chairman Johnson. Before I recognize Mr. Herger, let me just comment that this subcommittee will be looking at compensation and we do hope that you will get your opinions back to us, because the people who are the object of ordinary audits, in a sense, have done something to trigger that. It does not mean that they are wrong, but there is something about their return that triggers the attention of the professional in the IRS. These folks are selected at random and may be in substantial compliance, and for the majority there is no change. I think there is an equity issue here and we do want to look at that, and I appreciate the gentleman from Ohio raising it.

Ms. Stathis. There is a committee of the Commissioner's advisory group that has explored this issue and you may want to chat

with some of them.

Chairman JOHNSON. We will check with them. Thank you for that comment. I was not aware they were doing that.

Mr. Herger.

Mr. HERGER. Thank you, Madam Chair.

Mr. Brand, GAO has raised a concern that no effort has been made to retain auditors' workpapers in an accessible format for purposes of more detailed research. I am just wondering, is such data useful and, if so, are any steps being taken to make the data available?

Mr. BRAND. We are hopeful that the electronic gathering of information will do that and we will be able to more readily use those workpapers and gather them. That is a fairly awesome task, as you can imagine, because the electronic gathering of information is a summary of changes, data, and information, while the workpapers

themselves are often paper files. In fact, they are workpapers and it becomes more difficult to extract that.

What we want to do, and this is the whole heart of this process, what we are after is a methodology that would help us measure compliance and select workload in a way that is the least intrusive to the taxpayer and is the most efficient in revenue yield for us and for the government. Whatever we can do, we are open to suggestions on anything that we can basically do that will help us balance this particular process. So we accept the suggestions of the GAO and will try to act on them, yes, sir.

Mr. HERGER. Thank you.

You indicated that you will be including samples of partnership and S corporation returns in the sample. Will the issues be followed through to the partner and stockholder returns to measure the tax impact?

Mr. Brand. Yes, we do what we call pickups on various examinations. In fact, dependent again on what we find, we may go through and do the pickups and follow up with adjustments. We do those on regular examinations, too, if we get into a partnership return.

Mr. HERGER. Ms. Stathis, if we could return to an earlier question of how far back we would be going. I think we are shooting for 3 years, but I believe I heard you mention 1988 and back to 1981. Would you mind commenting on that?

Ms. Stathis. Mr. Hancock's point is that the data is old by the time they are available, 3 or 4 years out of date, and I was explaining to him that because the TCMP of partnerships, for example, has not been done since the 1981 tax returns, the data currently available is old.

We are in 1995, so the partnership data is 14 years old. We know that enormous changes have taken place in partnerships over that many years. So the TCMP data that is available to think about alternative changes to the tax system and how that might affect partnerships are very unreliable at this point.

Mr. HERGER. Very good. Thank you.

Chairman JOHNSON. Thank you. Mr. Levin.

Mr. LEVIN. Thank you.

I am sure I missed the earlier part of the hearing and your opening statements. As I went over the materials yesterday, I really was not clear, is the purpose of the hearing this morning kind of a traditional oversight hearing, or is there some contemplation of legislation that would alter the planned reinstitution of the program? I am not quite sure what our purpose is here this morning.

Chairman JOHNSON. Our purpose is to hear in more detail the IRS' plans for this audit. There has been some significant criticism of the TCMP, and were we to determine that that criticism was overwhelming, that the program ought to be canceled, we might want to do that.

The initial materials and testimony raised those questions, but certainly no one on the subcommittee to my knowledge has made any judgment that that might be the right thing to do. I think, more importantly, there are some ways in which the burden on the taxpayer might be alleviated. There are some ways in which the data might be gathered in a more timely fashion and reported to

us in a more timely fashion, so that we could make better use of it.

Some of us are interested in whether or not we are looking in the right place. This does not look at the underground economy, and that is of concern. So there is a variety of issues that are appropriate to this hearing. If the hearing material is overwhelmingly critical and can demonstrate that there is no value to this program, then this subcommittee would be forced to recommend to the full committee that the program be dropped. I do not see that that is the evidence of the hearing, but there will be people who will testify who believe that is the case.

So I would say that this was an oversight hearing in the best tradition of oversight. On the other hand, it is a hearing from which we would have to act promptly if we wanted to alter the course

planned by the executive branch.

Mr. LEVIN. At this point, there is no plan or—

Chairman JOHNSON. There is no preconceived plan of either legislation or action that might come out of this hearing.

Mr. LEVIN [continuing]. In simple terms—and you probably have already stated this—why have you done what you are doing? Why the reinstitution of the plan? Why is this now being recommenced?

Mr. Brand. We are concerned about the age of the data and also the fact that over a period of time, as your data gets old, your nochange rate starts to climb because of the fact that there is a change in law, et cetera. It also helps us allocate our resources in the areas where we can be most productive. It also helps us confirm what we believe from our examiners' experience in the field. Statistically, it helps us confirm that there are particular areas that need legislative change. We would normally be doing TCMP surveys on a more regular cycle.

The Service did enter into a policy debate around this with previous Commissioners over what should be the size of TCMP surveys, what should be the TCMP process. I think Ms. Stathis has testified previously to some of that particular debate. We reached the point within the Service that we felt it was time to go ahead with another TCMP. We wish to gain some additional information as I talked about in terms of market segments and geographical

area sensitivity, and felt the time was right to do that.

Mr. LEVIN. So you think that this step is important in terms of

your audit program?

Mr. Brand. It is important beyond the audit program, Mr. Levin. The Service for the last 20 years has, through a combination of enforcement and voluntary compliance, collected about 87.5 percent of what we estimate the annual tax base to be. We have been challenged, partially because of the economic situation of government, to improve our collection of that tax base to at least 90 percent, a 3.5-percent increase.

We believe that moving toward understanding market segments, being able to deal with market segments in a wholesale methodology, information, education, negotiations, is a better methodology than what we have done in the past, which have been specific one-on-one examinations to deal with areas of noncompliance. We think this is one of the most vital things we have, understanding compliance, where the noncompliance issues are, if we are going to reach our goal of increasing collection of that revenue base.

Mr. LEVIN. Thank you. I think between your comments in that response, I think it helps one understand why we are here today, and I am glad we are.

Thank you.

Chairman JOHNSON. For the record, I would note that this is the largest TCMP ever proposed. It is about three times as large as any program they have ever done. It is also structured differently and I think will give us better information. It is also going to go on over 24 to 30 months, and all of us on this side of the table are going to hear about it as a result of that.

There are a couple of questions that I want to complete for the record. There are then two votes on the floor, so we will recess between this panel and the next panel until the second vote is con-

cluded.

There are three matters that I think did not get sufficiently clarified. First of all, would the IRS have any objection to a sanitized data base being prepared and made available to qualified researchers outside the Service?

Mr. BRAND. I believe that that is a Treasury tax policy question, Madam Chairman, but we would be glad to provide the answer for the record.

Chairman JOHNSON. If you would do that, I would appreciate it. Also, if you would include in that how long you think that would take. That would be useful to us. At the same time, if you could be specific about when you expect you could get information back to this subcommittee and over what sort of schedule, that would be useful to us, too.

[The information requested was not available at the time of

printing.]

Chairman JOHNSON. Then there is the issue of the other expense line that GAO raised, and I do not believe we discussed adequately. The other expense line covers a multitude of problems, and it is one of the reasons why there is too little detail in that area, the lack of detail under other expenses will make it hard for us to indee issues like the misclassification of workers.

judge issues like the misclassification of workers.

Could you comment, Ms. Stathis, on why you think more information ought to be available under other. Mr. Brand, if you want to comment on any problems for the IRS in further detailing that section, I would be interested. To me, this is more important than workpaper issues. The workpapers I can appreciate researchers might like, but that is going to be a horrendous amount of information.

The other line it seems to me is very important, particularly in terms of spotting patterns of problems or patterns of noncompliance. We are dealing with some of the issues that frankly this subcommittee is really concerned with.

Ms. Staths. That is right. The parallel issues with other expenses and other income, it is sort of a catchall line where people put a lot of things. Unless there is enough information to separate out exactly what all was put there, it can be misleading as to what is really being observed.

The point we were making is that the TIES system IRS is hoping to use provides a lot of information on those details, and we are just hopeful that IRS will figure out a way to include that information in the TCMP data base. Otherwise, it will only be in the workpapers and somebody will have to go back and search through them. Even if the information is computerized, searching will still be necessary to find it. So I think it is really important in understanding the total picture to be able to have that information in the TCMP data base.

Chairman JOHNSON. Mr. Brand.

Mr. Brand. I would echo that, and it is our intention to make

sure we understand that area.

Chairman JOHNSON. There are two programs that you have developed, your primary computer program and your backup computer program. Did they allow for further detail being included in the other category?

Mr. BRAND. I would like to provide that for the record to make

sure of that answer.

Chairman JOHNSON. Thank you.

Last, the issue of appeals, what is the average number of appeals under the normal audit program, and in what percentage of those appeals is the taxpayer's liability reduced?

Mr. BRAND. I would like to provide that for the record, too,

Madam Chairman.

[The following was subsequently received:]

Responses to Questions from the Subcommittee on Oversight

A. MEASUREMENT OF TAXPAYER BURDEN

Background: There is no historical measure of taxpayer burden addressing the taxpayer's time, number of contacts and appointments, and out-of-pocket costs incurred in the course of compliance with a TCMP examination. The following information is estimated based upon Auditing Standards and Process Measures data compiled beginning April 1995. The Process Measures data have been accumulated from general program examinations in three of the seven IRS regions and capture the time and the number of contacts with the taxpayer and/or representative in the following four stages of the examination: Pre-audit Analysis, Inspection of Books and Records, Issue Resolution, and Closing. Contact with the taxpayer and/or representative takes place during Inspection of the Books and Records, and Issue Resolution stages. The time estimates are reflective of the actual hours the revenue agents and tax auditors allocated to the case in those stages when taxpayer contact takes place and assumes that taxpayers were active participants during these stages.

The number of times a taxpayer will need to meet with an examiner and the total time spent by the taxpayer in any examination (including TCMP) is dependent on many factors, such as the complexity of the return and the condition and availability of the taxpayer's books and records.

Question 1: An estimate of the average amount of time taxpayers must spend in meetings with IRS personnel when responding to a TCMP audit.

Answer: The process analysis data from the general program cases can be projected to TCMP cases using historical TCMP rates of increase in examination time as follows:

	General Program	TCMP Increase Rate	TCMP Examination
Revenue Agents	30	53%	46
Tax Auditors	7	88%	13

It is important to note that, for business audits, it is not customary for the taxpayer to be present for the entire process of the examiner's inspection of the books and records. Therefore, we would expect taxpayers or their representatives to participate in less than the 46 hours of examiner activities indicated above.

Questions 2: The percentage of the audits in which taxpayers must be seen more than once, more than twice.

Answer: Nearly 70 percent of individual returns examined in office examination are closed after the first appointment; an additional 20 percent are closed after the second appointment. Only 10 percent of all office examination cases require more than two visits with tax auditors. For returns examined by revenue agents, 24 percent of cases are closed after the second appointment, and 48 percent are closed after the fourth appointment.

Question 3: An estimate of the average amount of time taxpayers expend on all activities encompassed in their response to a TCMP audit, or in the alternative, a number of representative case studies.

Answer: There is no direct measure of the total amount of time taxpayers expend in the course of a general program or TCMP examination. The estimates computed in the answer to Question 1 reflect the total time expended by revenue agents and tax auditors during stages of the examination where taxpayer contact takes place.

Question 4: The estimated out-of-pocket cost to taxpayers.

Answer: The data from general program process measures indicates that 80 percent of the taxpayers examined by tax auditors in office examination did not have representation. Of the business returns examined by revenue agents in the field, nearly 60 percent were closed without representation. It is not possible to accurately estimate the out-of-pocket costs expended by taxpayers in the course of a TCMP examination.

B. APPEALS

Question 1: In the normal audit program, what is the average number and percentage of general program cases that are forwarded to Appeals?

Answer: For the period beginning October 1994 and ending June 1995, eight percent of general program cases were forwarded to Appeals.

General Program Cases	Cases Forwarded to Appeals	Total Cases Closed	Percentage of Total
Individual	14,931	239,145	6%
Corporate & Other	13,094	100,420	13%
Coordinated Exam Program	1,101	4,817	23%
Training	160	22,822	1%
Total	29,286	367,204	8%

Question 2: What percentage of those cases result in a reduction of the taxpayer's liability?

Answer: The Appeals function accounts for reduction in the taxpayer's liability using the total tax deficiency and does not maintain statistics by the number of cases. Of the eight (8) percent of cases forwarded to Appeals from October 1994 through June 1995, the total deficiency was reduced by 71%.

(dollars in thousands)	Total Cases	Revenue Agent	Tax Auditor
Proposed Deficiency	\$5,586,499	\$5,404,264	\$182,235
Revised Deficiency	\$1,622,141	\$1,556,271	\$ 65,870
Percentage Reduced Deficiency	71%	71%	64%

Question 3: How many individual and corporate returns included in the last TCMP surveys were forwarded to Appeals?

Answer: In the most recent TCMP survey of individuals (Form 1040 filers) 863 of the 54,088 taxpayers, or **1.6**%, appealed the results of their audit. In the most recent TCMP survey of corporations (Form 1120 filers) 746 of the 18,138 taxpayers, or **4.1**%, appealed the results of their audit.

TCMP Survey	Cases Forwarded to Appeals	Total Cases Closed	Percentage of Total
1988 Survey of Individuals	863	54,088	1.6%
1987 Survey of Businesses	746	18,138	4.1%

Question 4: What percentage of those cases resulted in a reduction of the taxpayer's liability?

Answer: The Appeals follow-up information has not been perfected. Therefore, we cannot directly measure the appeals sustension rate. However, since the appeal rates for the last two TCMP surveys are very low, we feel that the sustension rate is not a significant issue.

C. ADDRESSING TAXPAYER BURDEN

Question 1: Given the number of issues and the higher standard of documentation that taxpayers must meet in responding to a TCMP audit, how can the resulting inequity in adjustments between TCMP audits and non-TCMP audits be addressed?

Answer: The TCMP process does not increase the depth of the audit. As is normal operations, examiners are directed to use good judgement in investigating issues. In the TCMP process, examiners are directed to "consider" each line item. That does not mean that each line item must be investigated, and an adjustment resulting in additional tax does not have to be made if the adjustment is a small dollar amount. This is the same expectation as in other audits. However, in a TCMP audit, the adjustment is recorded on a checksheet regardless of whether the adjustment is made to the taxpayer. TCMP results often point to the fact that small dollar value compliance issues, if widespread enough, can amount to large compliance problems.

Question 2: What are the recommendations of the Commissioner's Advisory Group committee that studies the issue of taxpayer compensation for participation in TCMP audits?

Answer: The following is excerpted from the meeting minutes of the Compliance Subgroup of the Commissioner's Advisory Group for February 1, 1994:

"...reducing unnecessary burdens on taxpayers should be an important priority. There is a high level of no-change audits under TCMP because of the random selection of returns. These taxpayers are participating in a research project that has substantial benefits for the tax system as a whole. Many of the people the Subgroup members spoke to, both inside and outside the Service, felt that there should be a clear recognition of this in the way that the TCMP audits are handled. The Subgroup heard a complete spectrum of views on this -- (i) treating TCMP audits like any other audit, even for compliant taxpayers, (ii) reimbursing compliant taxpayers for some portion of the cost of the audit, (iii) giving participating

taxpayers a "hotline" number to assist them in handling tax problems that occur for the next couple of years, (iv) waiving certain penalties or interest, or even tax, and (v) granting even more extreme waivers to cooperative non-compliant taxpayers. The Subgroup is not endorsing any of these suggestions at this time but remains concerned about the burden that TCMP imposes on taxpayers, especially those who are found to have substantially complied with the law. The Service should continue to study this issue."

D. THE TCMP PROCESS

Question 1: Do both TIES and the backup data collection systems collect detailed information on the "other" categories of income and expenses?

Answer: No. The new TCMP checksheet portion of TIES is designed to allow for one issue to be captured per line item with a causal code and Uniform Issue Listing (UIL) code to be attributed to the largest issue, if multiple issues are present. The backup data collection system, Electronic Data Gathering for Examination (EDGE), is similarly designed. The TIES workcenter, however, normally allows for writing a Revenue Agent Report (RAR) that accounts for multiple issues related to a single line item.

Question 2: Will the detailed information on the "other" categories of income and expenses be recorded in the TCMP database for purposes of analysis?

Answer: No. The database that will capture and archive the TCMP results is not designed to display multiple adjustments per line item. The file transfer, data diskette creation, and data accumulation programs are likewise not designed to address multiple adjustments per line item. It is our intent to capture the causal code and UIL code for the largest adjustment to an "other" line item. It is important to note that this capture methodology is a vast improvement over prior TCMP surveys. In prior surveys, no information on causal codes or UIL codes was captured.

If there is interest in analyzing instances where multiple adjustments occur on an "other" line item on a return, we will be able to determine when multiple adjustments were made to a line item by analyzing the comments section of the TCMP file which will be available in computer sensible format on the TCMP file at the conclusion of the survey.

Question 3: If this is not to be done, how will compliance on the specific issues be measured and matched across the various types of returns?

Answer: It has always been our contention that there are relatively few times that multiple adjustments will need to be made to a single line item. Until GAO's report, no other internal or external stakeholders had requested sub-line-item, breakdown of information. Further contact with GAO revealed that in the cases with an adjustment of an "other" line item, multiple adjustments were present only three (3) percent of the time. Since cases where "other" line items are adjusted are, in turn, a subset of the total sample, the percentage of the cases in the upcoming TCMP where multiple adjustments would need to be made to an "other" line item would be expected to be substantially below three percent.

Comparison of compliance measures across form types does not depend upon multiple adjustments per line item. Rather, effective comparison depend upon consistent treatment and capture of information across form types. Regardless of the data capture mechanism the Service ultimately uses for TCMP, consistent treatment and capture of compliance information has been our utmost concern.

Source: IRS

Chief Compliance Officer September 14, 1995 Chairman JOHNSON. I would like you to respond to the criticism of the TCMP that auditors are given little leeway to make the kinds of judgments that IRS reviewers commonly make and that tends to increase the number of adjustments made on appeal in the taxpayer's favor.

Mr. Brand. The issue here is that we do require our examiners to, in fact, look at the line items. Again, the depth of that verification is the judgment that the auditor can exercise. As you understand, we are trying to determine compliance on a line-by-line basis so we can then use this to develop our discriminate function activities so we can select those tax returns that are most in need of change in future situations. So I believe it is a valid statement. Whether it is a criticism or not—

Chairman JOHNSON. I wish you would give some thought, Mr. Brand and Ms. Stathis, to this issue. I can understand that for research purposes you might want to draw a very hard line. But I think in fairness to taxpayers, they at least be given the information that under this program we do draw harder lines and the likelihood of success on appeal is very great, since the judgment that IRS officers could normally exercise would probably read this differently.

We have to do something to make sure that, in a sense, subjects or victims of these audits are not unduly punished. For many, the matter of going to appeal is a formidable challenge and many just may be simply discouraged from doing that because it is formidable. I think this issue of the different and harder standard that tax-payers are held to under the TCMP is a matter of equity that we need to think through, and we would like your recommendations as to how to handle that.

Mr. BRAND. Just one quick response in terms of the standard. The standard that is the same is that we do not assess de minimis amounts. So even though there is an adjustment as a result of a TCMP audit, it still would not result in additional tax. We would record that information and it would help us select returns. But we are not interested in assessing de minimis amounts. Again, we maintain those assessment levels as confidential, but we would not assess a small amount of tax, even though we would record it.

Chairman JOHNSON. Thank you very much. I thank the panel.

The next panel, we will use the lights both for those who are testifying and for the members. I always feel it is important that we have as much time as we want to get the professional administrators' side of these issues.

[Recess.]

Chairman JOHNSON. The subcommittee will reconvene. I regret that I do have another obligation at 12:15 that requires that I excuse myself, so I will not be able to hear all of the testimony, although I intend to return. But I am very anxious to hear as much as possible, and so I am going to start with Mr. Goldberg and move to you, Mr. Gibbs, and Mr. Sparrow. If you will adhere as closely as possible to the 5-minute rule, I would appreciate it.

Mr. Goldberg.

STATEMENT OF FRED T. GOLDBERG, JR., PARTNER, SKADDEN, ARPS, SLATE, MEAGHER & FLOM; AND FORMER COMMISSIONER, INTERNAL REVENUE SERVICE

Mr. GOLDBERG. Thank you, Madam Chairman, for the opportunity to appear before you today. I would like to submit my written statement for the record. I will keep my remarks brief.

It seems to me the place to start in thinking about the proposed 1994 TCMP is with what we know. What we know is that it will cost the government more than \$550 million. While there are no precise measures, I believe it will cost taxpayer citizens of this country well more than \$1 billion in out-of-pocket costs. I believe that it will consume hundreds of millions of hours of their time.

Second, we know that what we are measuring or at least what we have historically measured is not whether the taxpayers pay the proper amount of tax. What we are measuring is the revenue agent's views as to the law, the revenue agent's views as to whether the taxpayer has complied with applicable recordkeeping requirements, and whether the taxpayer has satisfied the revenue agent with respect to factual issues in dispute. Finally, we know that this will take 4 years or more to complete.

What we do not know are the benefits that have been claimed for the proposed 1994 TCMP, nor do we know whether there are better ways to accomplish the stated objectives. In very brief terms, five benefits have been cited for TCMP. The first is the historically intended use of TCMP, which was to permit the IRS to score and

better select returns for audit.

It is often claimed that the result of TCMP is a decline in nochange audits of more than 40 percent to less than 15 percent, and to an increase in yield from examinations that are conducted. While TCMP has performed an important function in this regard, I believe that the primary factors causing that decline have little to do with either TCMP or the formula. I believe those declines are largely attributable to the IRS information returns program, which was nonexistent in the late sixties, to a dramatic decline in audit coverage of more than a sixfold decline, and to a more effective targeting of the special examination programs.

The question is—and I believe this is the question that should always be asked—is it worth \$550 million in taxpayer dollars, is it worth what I believe to be \$1 billion-plus of citizens' money, is it worth hundreds of millions of dollars of citizens' time to achieve whatever improvements might be achieved in the current IRS procedure for scoring returns? My own judgment is that the answer is no. I believe that improvements in scoring could be accomplished, but I believe they could be accomplished far less expen-

sively and far less intrusively.

A second argument is that TCMP helps to identify compliance trends. I believe that any study that takes more than 4 years to complete calls into question on its face that assertion. Beyond that, I would suggest by way of example the most single important noncompliance trend of the late seventies and early eighties was tax shelters. I believe that TCMP played no role in identifying that trend. I believe the TCMP, if anything, inhibited the agency's ability to respond.

A third point is that the TCMP data facilitates the development of compliance legislation. Others have cited examples ranging from toys for tots to alimony reporting to State income tax refund reporting. I believe that in each and every one of those instances, the same results could have been accomplished at a tiny fraction of the cost and far more rapidly, if folks had sat around and thought carefully about the tax system, and the process of thought, reflection, contemplation would have led to those results far more effectively. TCMP was useful as a revenue estimating device, but I think that is the end of it.

Tax cap studies, again I question their value. I also question whether \$550 million of the taxpayers' money, more than \$1 billion of our citizens' out-of-pocket costs and hundreds of millions of hours, is worth whatever improvements could be achieved.

I think it is time to start over. TCMP served an invaluable purpose 25 years ago, but we are trying to retrofit a battleship and turn it into a speed boat. That effort is doomed, in my judgment,

to fail.

I believe if I could commend you to one piece of testimony, it is not my own, it is Dr. Scheuren's testimony. I have known Fritz for years. I was unaware that he was going to testify today. I believe that he provides a practical, workable alternative that is far less expensive, far less intrusive, and will provide far more valuable results.

Thank you very much.

[The prepared statement follows:]

JOINT STATEMENTS OF FRED T. GOLDBERG, JR., MICHAEL J. GRAETZ, AND THOMAS M. GOLDSTEIN AS PRESENTED BY FRED T. GOLDBERG, JR.

Madam Chairman and Members of the Subcommittee:

We appreciate the opportunity to submit this statement on the subject of the IRS' proposed Taxpayer Compliance Measurement Program for the tax year 1994 (the "1994 TCMP"). We are submitting this statement solely in our individual capacities and not on behalf of any client or organization.

In brief, our views are as follows: (1) It is universally acknowledged that the 1994 TCMP will be expensive and intrusive, and will take a long time to complete and evaluate. (2) The case has not been made that the reasonably anticipated benefits from the 1994 TCMP will justify either its cost to the government or its burden on taxpayers. (3) The benefits likely to result from the 1994 TCMP could be achieved more effectively and efficiently through other IRS research and enforcement strategies.

- I. What We Know About TCMP We should begin with what we know about the proposed 1994 TCMP. It is a major investment of resources by the IRS; it will impose a substantial burden (without compensation) on taxpayers unlucky enough to be selected for TCMP audits; and it will take years before we learn anything from the effort.
- A. Cost to the Government The IRS estimates that the 1994 TCMP will cost approximately \$550 million over three years, more than six times greater than the cost of the 1988 TCMP. To put this number in perspective, it represents more than 30% of what the IRS would like to spend over the next three years on the supplemental revenue initiative that was approved by

Mr. Goldberg is currently a partner with the law firm of Skadden, Arps, Slate Meagher & Flom. He has served as IRS Commissioner (1989-1991) and as Assistant Secretary Tax Policy (1992). Professor Graetz is currently the Justus S. Hotchkiss Professor of Law at Yale Law School. He has served as Deputy Assistant Secretary (Tax Policy) (1989-1991) and Assistant to the Secretary and Special Counsel (1992). Mr. Goldstein is currently a student at Yale Law School and a summer associate with Skadden, Arps, Slate, Meagher & Flom.

In the interest of full disclosure, Mr. Goldberg notes the following: (1) Mr. Goldberg's comments during the hearing itself reflect solely his own views, and may not necessarily reflect the views of Professor Graetz or Mr. Goldstein. (2) While Mr. Goldberg is testifying in his individual capacity, the concerns expressed in the written statement and his testimony are the same as those he raised as IRS Commissioner and as Assistant Secretary (Tax Policy). (3) Mr. Goldberg was the "Commissioner" who was referenced in the 1993 and 1994 General Accounting Office ("GAO") reports on TCMP. Tax Administration: IRS' Plans to Measure Tax Compliance Can Be Improved (GAO/GGD-93-52, Apr. 5, 1993), and Tax Compliance: Status of the Tax Year 1994 Compliance Measurement Program (GAO/GGD-95-39, Dec. 30, 1994).

Congress in 1993. It also represents more than 25% of what the IRS will probably spend on Tax Systems Modernization over the next three years. It is more than three times greater than the 3-year budgets for both the IRS Statistics of Income and Research Division functions.

B. Burden on Taxpayers Beginning in October of this year, more than 150,000 individuals, families and small businesses will be subject to TCMP audits. While there are no reliable estimates of the time that these taxpayers will spend or their out-of-pocket costs, no one doubts that TCMP audits are intrusive, burdensome, and expensive. Taxpayers must justify—to the satisfaction of IRS agents—every item on every line of their 1994 returns. If you claimed the right to file a joint return, you have to show the agent your marriage certificate. If you claimed dependents, you better have birth certificates available for the agent. Forget about simply reconciling reported income by matching W-2's and 1099's. You must explain every bank deposit and every investment to show that you had no unreported income. If it appears to the IRS agent that you are living beyond your means, there will be more explaining to do. Your "word" and some reconstructed notes will be worth little; contemporaneous documents and the affidavits of third parties are often required.

More than 60,000 1994 TCMP audits will involve business enterprises (corporations and partnerships), and most individual TCMP audits will involve taxpayers with complex returns. In the absence of any hard data, it seems reasonable to speculate that out-of-pocket costs (including employee and preparer time) will be in the range of \$5,000 to \$10,000, and that the average individual will spend at least 20 hours preparing for and dealing with a TCMP audit. On this basis, the 1994 TCMP would impose between 750 million and 1.5 billion dollars in unreimbursed, private out-of-pocket costs on American citizens, and consume more than three million hours of their time. Coupled with the IRS's costs, the 1994 TCMP is an undertaking that will cost more than one billion dollars and could well cost several billion dollars.

What do we learn from imposing this burden? For the moment, consider these results from the 1988 TCMP: (a) more than 50 percent of those audited owed no additional tax; (b) about 7.5 percent of those audited were entitled to refunds, averaging \$284; and (c) the average proposed adjustment for the 40 percent regarded by the agents as owing additional tax was \$780.

C. Time To Completion The IRS expects to complete the 1994 TCMP by the end of 1998. The December 1994 GAO report expressed doubt that the IRS would start as scheduled, and concluded that: "Even with this start date, the TCMP results cannot be used to fully

In light of stated concerns over the burden imposed by TCMP, and the IRS' stated objective of reducing taxpayer compliance costs, it is somewhat surprising that the IRS does not plan to gather data on the time and money that taxpayers spend on TCMP audits (much less, gather data on compliance burdens faced by taxpayers in filing their original returns).

measure compliance levels or develop audit selection formulas until the end of 1998. By this time, the data will already be 4 years old." At that point, it should be noted, we may have a substantially different tax system.

II. What We Don't Know About TCMP Consider next what we don't know about TCMP. What is TCMP measuring? What will TCMP teach us? What will we do with what we learn?

A. What Does TCMP Measure? As the name implies, TCMP is intended to measure taxpayer compliance. Proper "compliance" means paying the proper amount of tax. But far too often that may be an uncertain number. Historically, TCMP has told us the amount of adjustments proposed by the revenue agents conducting the TCMP audits. TCMP data has never reflected final determinations of liability. TCMP measurements therefore turned on a particular revenue agent's view of the law, the revenue agent's conclusions in light of the taxpayer's record-keeping habits, and ultimately the revenue agent's factual determination when factual matters were in dispute.

While there is no reliable data addressing these issues, IRS sustention rates in other areas are often less than forty or fifty percent. This raises a yellow caution flag in taking literally the conclusions drawn from TCMP data. The IRS has indicated that it will be able to track the results of 1994 TCMP audits through any subsequent administrative appeals or litigation. However, it is unclear whether the IRS intends to base the 1994 TCMP data on the final resolution of these cases.

³ GAO/GGD-95-39, at 3.

While erroneous or controversial revenue agent interpretations of the law confound some TCMP data, record-keeping and "standard of proof" issues are far more troublesome. For example, taxpayers filing joint returns, and claiming several dependents, will be subject to numerous adjustments during a TCMP audit if they do not produce marriage and birth (or adoption) certificates, and cannot demonstrate that they have provided more than one-half the dependents' support (as required by Code § 152(a)). Many of these taxpayers would prevail during the administrative appeals process or in litigation.

Similar situations may arise in many other areas, e.g., disallowed deductions or the assertion of additional earned income based on the agent's determination regarding "unreasonable compensation"; disallowed deductions and the assertion of additional income based on the agent's determination that a company has failed to adequately document expenses as business-related (rather than personal); increased capital gains tax liability based on the agent's determination that a taxpayer has failed to establish basis and/or holding periods; worker classification disputes over employee versus independent contractor status.

Moreover, many people will no doubt have exhausted their taste for dealing with the IRS after experiencing a TCMP audit. As a result, they may be less inclined than taxpayers undergoing regular audits to pursue those issues through appeals, particularly if the dollar amounts are not substantial. Indeed, some taxpayers may make this kind of cost-benefit calculation during the TCMP audit itself (choosing, for example, not to spend \$2,000 and a lot of time documenting and challenging a potential adjustment of \$1,500).

- B. What Will TCMP Teach Us; What Will We Do With What We Learn? TCMP is supposed to accomplish four objectives: (1) improving the selection of returns for examination; (2) measuring the overall tax gap and its primary components; (3) permitting the IRS, and perhaps Congress to design and implement improved compliance strategies; and (4) providing useful statistical information to other users (e.g., the Commerce Department and private researchers).
- 1. Selecting returns for audit. Originally, TCMP's sole purpose was to help the IRS select returns for audit. The application of various statistical techniques to TCMP data permitted the IRS to "score" returns based on their anticipated audit yield. In this respect, TCMP has made an important contribution to tax administration. Indeed, the most frequently cited data in defense of TCMP is that "no change" audits have declined from more than 43% in 1968 to less than 15% for 1991, and that examination yields per return audited during that period have increased.

Having said as much, however, it grossly overstates the case to ascribe such results entirely to TCMP. The decline in no change audits and increased yields have resulted largely from the following (particularly since the late 1970's): (1) the development and implementation of a comprehensive information returns reporting and matching program; (2) the dramatic decline in audit coverage (to about one-sixth its level in the 1960's); and (3) the improved focus of special program audits.

In this context, two points are worth emphasizing. First, we do not quarrel with the notion that the IRS should minimize no change audits and maximize yields. However, we are not convinced that this objective justifies the 1994 TCMP.

- It is far from clear that the proposed TCMP would improve materially the "scoring" techniques that the IRS currently has in place and regularly modifies in light of other information it receives (including information from other audit and enforcement activities).
- The "general audit" program is currently at a minimal level of less than one percent of returns filed; it has been at that level for some time; it seems very unlikely to expand in the years ahead. With coverage at such low levels, IRS has many more potential high yield returns than it can audit. Any improvements due to the 1994 TCMP would be likely to have little practical value.

Improvements in sampling and statistical techniques suggest that the IRS' "scoring" objectives could be satisfied with samples that are both much smaller and more narrowly targeted than the proposed TCMP universe (particularly if such studies were conducted more frequently and completed more quickly).

Stated differently, the key question that must be asked is: Given current IRS "scoring" techniques, alternative ways to improve those techniques, and the projected level of audit coverage, do the reasonably anticipated benefits of the 1994 TCMP justify the costs to the government and the costs and other burdens to be imposed on taxpayers, taking into account the time it will take to complete and evaluate the effort? Maybe that case can be made, but based on information provided by the IRS and others to date, we believe the answer is no.

Even if that question were answered "yes," and the proposed 1994 TCMP were the most cost effective way to improve the general audit program, a second question still requires an affirmative answer. Budget realities force the IRS to make hard choices and set priorities. In light of all the other efforts that the IRS could pursue to improve voluntary compliance and/or reduce taxpayer burden, is the 1994 TCMP the best place to allocate scarce resources? Once again, it may be possible to make a case for the 1994 TCMP. But once again, on the information provided to date by the IRS and others, we believe that the answer is no.

- 2. <u>Measuring the tax gap and its components</u>. While TCMP was not originally intended for this purpose, it has been used for some time as a basis for estimating the overall tax gap and its components. Here again, TCMP may have a useful purpose. We now know that:
 - In absolute dollar terms, the aggregate tax gap is quite large.
 - Most noncompliance involves the underreporting of income.
 - Compliance levels are extremely high in circumstances where there is withholding, and relatively high when there is effective information reporting and matching.
 - Compliance levels are low in circumstances where there is the opportunity to understate tax, such as where there is no withholding and no effective information reporting. It is even lower when the medium of payment is cash and the payor has no need for any record to substantiate payment for purposes of a tax deduction or a reimbursement claim.

For example, Professor Bradley Efron, Department of Statistics, Stanford University, has suggested that sample sizes as small as 1,000 might be sufficient for most purposes.

While much of this "learning" seems like common sense, various TCMP studies have provided useful order-of-magnitude measures and may have told us something about trends over time.

Nevertheless, there seems to be little real benefit to be gained from a new study of the tax gap based on the 1994 TCMP. In particular:

- From a qualitative standpoint, we are likely to learn nothing new about the overall tax gap and its major components.
- From a quantitative standpoint, the tax gap estimates are very crude measures. In absolute dollars, they are probably too high -- or too low -- by many tens of billions of dollars. Given the limitations on other researchers' development and use of individual taxpayer-level data, we probably will never know how far off the mark these estimates are, and never even know the direction of the error.
- From a quantitative standpoint, the 1994 TCMP will provide little reliable data regarding changes in voluntary compliance levels, much less the magnitude of any such changes.
- From a quantitative standpoint, it is not clear that estimates derived from the 1994 TCMP will be materially different, or more accurate, than projections made from other data sources.

It has been suggested that the 1994 TCMP will provide far more accurate tax gap estimates, and will provide a useful baseline for determining whether the IRS achieves its stated goal of increasing voluntary compliance levels from "about 84%" to over 90% by the year 2000.7 This rationale is not persuasive for several reasons: (1) it suggests far higher reliability in the estimates than is warranted; (2) there are other, far less costly and intrusive ways to develop estimates of at least equal reliability; and (3) the resources in question could be better used to help achieve the stated objective.

In this context, we also question the underlying justification for ongoing estimates of the overall tax gap. What will happen differently if, based on the 1994 TCMP, the IRS estimates a tax gap of \$75 billion

There are may reasons to question whether the 1994 TCMP will permit a reliable analysis of compliance trends. For example, the IRS has made substantial changes in audit techniques, training programs, and the information provided to its auditors. It has also made substantial changes in its data collection and retrieval systems. See generally, GAO/GGD-95-39. Margins of error are quite large (particularly where unreported income is at issue), and there is no reason to believe the bias is the same for all TCMP studies.

GAO/GGD-93-52, at 12.

....\$150 billion\$300 billion? What will Congress or the IRS do differently if the 1994 TCMP produces estimates that voluntary compliance levels have gone up 2% have stayed the same ... have declined 2%? Will the Administration and Congress seek different levels of funding for the IRS? Will the IRS change its allocation of resources? The tax gap estimates, whatever they may be, seem likely to have little discernable impact on policies pursued by Congress and the Administration. Moreover, we find it difficult to imagine any different impact, whether the estimates are derived from the 1994 TCMP or from other data sources.

3. <u>Improving voluntary compliance</u>. Another justification for TCMP is that it improves voluntary compliance by helping the IRS identify trends in noncompliance and by leading to specific legislative initiatives. We believe these particular claims are also overstated.

(a) Trends in Noncompliance. Since it will take until the end of 1998 to complete the 1994 TCMP, claims regarding the ability of this exercise to identify new trends in noncompliance are somewhat suspect. The tax law, tax planning, and the context in which those activities take place are all in flux. In an environment characterized by frequent change, a study that takes four years to complete can at best be of limited use in identifying emerging trends.

One practical illustration of this point is provided by tax shelters and the 1976, 1979, and 1982 individual TCMP studies. During the late 1970's and early 1980's the retail marketing of tax shelters was easily the most important compliance problem of that period -- yet the TCMP studies did nothing to help identify the trend as it emerged. If anything, the IRS commitment to its "scoring" and return selection techniques distracted the IRS and delayed and distorted its response. The tax shelter phenomenon could have been identified and responded to far more rapidly through observation and reflection in a work environment that encouraged employees to "think" about the tax system, to communicate with each other, and to focus on events in the "outside" world.

(b) Specific Legislative Initiatives. Despite recent IRS claims, TCMP is no key to specific legislative initiatives. The critical elements are an appropriate analytical framework, observation and reflection, sound research and sampling, common sense, and creative thinking. On occasion, TCMP data has been used in recent years to test hypotheses and estimate potential revenue gains from proposed compliance legislation. In this context, however, TCMP data is expensive and often unsuited to the task. There are more efficient and effective ways to identify areas of noncompliance, and to assess the potential impact of various compliance measures.

Two examples illustrate this point: legislation requiring taxpayers to obtain and list Social Security numbers for their claimed dependents ("TIN's for tots"), and the current debate over compliance with the Earned Income Tax Credit ("EITC").

TIN's for tots. One of the success stories frequently attributed to TCMP involves the TIN's for tots legislation enacted during the 1980's. Myth has it that TCMP caused IRS to figure out that taxpayers were overstating the number of dependents and that the problem might be solved by requiring taxpayers to obtain and list Social Security numbers for their children. Some have suggested that the revenue gains from just this one change more than cover the costs of TCMP.

In reality, the process was, as it should be, far different. The starting point was the recognition that voluntary compliance improves when the taxpayer has the information necessary to comply with the law and knows that the IRS has independent means to verify such compliance. The TIN's for tots proposal was the logical outgrowth of this analytical framework. Common sense suggested that, with no means for IRS to easily verify claims, taxpayers could overstate their dependents with no real fear of challenge. Requiring taxpayers to obtain and list Social Security numbers seemed like an obvious, relatively unintrusive way to improve compliance. TCMP data verified the hypothesis and provided a revenue estimate for purposes of scoring the legislation. All of the **thought** that prompted the TIN's for tots legislation could and should have been accomplished without TCMP. The hypothesis could have been tested, and revenues estimated, through a targeted research effort that would have been inexpensive, unintrusive, and completed in several months.

EITC reforms. The 1988 TCMP data has been cited frequently in Congress and by the media for the proposition that the EITC is rife with fraud and noncompliance. This assertion is misleading for several reasons. First, as noted above, the 1988 TCMP measured a revenue agent's judgement as to whether a taxpayer had complied with the law and applicable record-keeping requirements. We believe that many of the adjustments proposed during the 1988 TCMP audits would not have been sustained on administrative appeal or in litigation. The fact that a low income family cannot produce marriage and birth certificates and detailed information regarding family budgets -- to satisfy the demands of an IRS agent -- proves very little. To be perfectly frank, while EITC changes may be warranted, we would not base any policy decisions on the noncompliance estimates provided by the 1988 TCMP.

Second, the 1994 version of the EITC is far different from the 1988 version of the EITC. Moreover, the IRS is now taking numerous steps to improve compliance with the law as amended. The simplifying changes since 1988, together with ongoing IRS efforts in this

As a preliminary matter, while the 1988 TCMP data suggested high levels of noncompliance, it did not suggest that the noncompliance was intentional or fraudulent.

area, should have greatly reduced levels of noncompliance. 9

The important point is that the 1988 TCMP has hindered, not helped, thoughtful analysis of the EITC. The 1994 TCMP will come far too late to affect the EITC reform discussions currently under way. Given the currency and importance of this issue, all concerned would be better served by a well-designed and properly executed research program that might be completed this fall.¹⁰

4. Meeting the needs of other users. Another argument often advanced in support of the 1994 TCMP is that it will serve the needs of other users, such as the General Accounting Office, the Joint Committee on Taxation, the Treasury Department's Office of Tax Policy, the Commerce Department's Bureau of Economic Analysis, various state governments, and private sector researchers.

As a preliminary matter, of course, anyone who relies on data always wants more. The question is whether the benefits of additional data justify the costs of collection. With respect to uses directly related to the tax system, we do not believe that the either IRS or these other potential users have made the case. We believe that the principal objectives to be served by the 1994 TCMP could be achieved more effectively and efficiently, at less cost to the government and with less burden on citizens.

One way to attempt a "cost-benefit" analysis as it relates to other potential users of the 1994 TCMP data would be to ask them the following question: how much would you be willing to compensate the IRS and taxpayers for costs they incur due to the 1994 TCMP?

believe the IRS, taxpayers and tax administration would be better served by abandoning plans for the 1994 TCMP. Quite simply, we are not persuaded that the likely benefits will offset the certain costs to the government and taxpayers.

While TCMP has served a useful function for many years, it was designed in a different era to meet very different needs. During the past 25 years, research techniques, technology, and the tax system itself have all changed dramatically. Efforts to "improve" TCMP are

We are aware of the January 1994 study showing that noncompliance levels are improving but remain rather high. In our view, that study suffers from the same flaw as all TCMP data -- it reflects the IRS position on audit, not a final determination. It also illustrates the danger of targeted "research" studies that are neither well designed nor well executed (e.g., a small sample of returns filed during two weeks in January). Compliance research projects should not be a hasty response to external pressure; they should be the result of well-conceived research strategies.

See, note 9, supra.

a little like trying to reconfigure a battleship into a speed boat. It is better to start over. Among the steps that the IRS should consider are the following:

- More frequent (perhaps annual) audits that rely on far smaller sample sizes and different audit techniques to facilitate the scoring of returns and tax gap estimates.
- The emphasis should be on thinking about compliance issues. IRS needs to do compliance research -- far more than it does today -- but it needs to design targeted research programs to test hypotheses and provide data that can be used in formulating legislative, regulatory and administrative initiatives.
- Recognize that "compliance" is not the only (or necessarily most important) issue to address in designing research programs. Consider, for example, studying taxpayer compliance burdens and whether various tax laws are achieving their stated policy objectives.
- Develop and implement a long-term research strategy, but place a premium on reasonably quick responses and flexibility. Most research efforts should be completed in less than a year. IRS must accept the fact that projects on the drawing boards will often be replaced by new initiatives in response to changing conditions.

IV. A Word of Caution We believe that the IRS should not go forward with the 1994 TCMP for two reasons: (1) the anticipated benefits do not justify the costs; and (2) the IRS should revise its research strategies to meet the current needs of tax administration. But we are far less confident that the Congress should preclude the IRS from going forward.

It is certainly appropriate and important for this Committee to ask hard questions and impose a strict standard of accountability. However, the final decision regarding administration of the tax laws generally should be left to the IRS. In our experience, efforts to "micromanage" tax administration through specific legislation or the appropriations process often have been counter-productive. We are not suggesting that Congress should never intervene in administrative matters; rather, we urge this Committee and the Congress to exercise great care when deciding whether to take that step.

Chairman JOHNSON. Thank you very much, Mr. Goldberg. Mr. Gibbs.

STATEMENT OF LAWRENCE B. GIBBS, PARTNER, MILLER & CHEVALIER; AND FORMER COMMISSIONER, INTERNAL REVENUE SERVICE

Mr. GIBBS. Madam Chairman, it is also a pleasure for me to be here with you today.

I will get right to the point. I rarely disagree with my good friend Fred Goldberg. On this issue, however, we are in disagreement. I

would like to pinpoint, though, where we disagree.

I think the function that these hearings will perform is a good function. I think it is time that we take a hard look at TCMP. It has grown and changed over the last 30 years, and I think it is appropriate that it continue to do so. I would not suggest that we abandon TCMP, but I would suggest—and I agree with Fred in this regard—that there are problems, there are deficiencies, there are shortcomings.

The only thing that I would say is this. I would put it to you this way: While I was Commissioner from 1986 to 1989, there were two questions that I was asked by taxpayers, the media, and the Congress: No. 1, I was asked what is the level of taxpayer compliance with our tax law in this country? No. 2, how much are we losing in taxpayer noncompliance? I felt I had to have credible answers based on something that taxpayers and others would feel is credi-

ble in order to respond to those questions.

My point is that, with all of its faults and all of its shortcomings, TCMP is better than anything that has been suggested to replace it as an alternative. I would simply say that, in addition to Commissioners being asked those questions, I suspect you are asked those questions by your constituents. I know I was asked those questions by your predecessors, and it is important to have not only answers, but credible answers, answers that come from a comprehensive overall credible methodology to provide answers.

If we can change that methodology, if we can make it better, fine. But we had better not abandon the methodology until we have something else in place. To suggest that we do so before we have something else in place I think is inviting trouble that can lead to disrespect and lack of confidence—even more than is reported that

we have at the present time.

So, for that reason, I would say improve TCMP and change it, change it drastically, but, for goodness sake, do not abandon it until we have an overall comprehensive credible system that will provide the results that TCMP is presently providing to the folks that are using those results.

Thank you.

[The prepared statement follows:]

STATEMENT OF HON. LAWRENCE B. GIBBS PARTNER, MILLER & CHEVALIER

Madam Chairman and Members of the Subcommittee:

I appreciate the opportunity to submit this statement in connection with this hearing to examine the Taxpayer Compliance Measurement Program of the Internal Revenue Service. I served as Commissioner of Internal Revenue from 1986 until 1989, and I presently am a member of the law firm of Miller & Chevalier in Washington, D.C.

I add my congratulations to those of others on your decision to hold this hearing to examine the IRS' TCMP because I believe that it is timely and important to examine this program at the present time. Good questions are being asked about the program, and suggestions are being made to improve its effectiveness. In this process I believe the TCMP, taxpayer compliance, and our overall tax system will benefit.

The TCMP has been in effect for over thirty years. During that time it has grown and changed to accommodate the needs of the IRS, Treasury, Congress and others who have had an interest in improving tax administration and the compliance with our tax laws. Although TCMP has its drawbacks and its limitations, it is the only comprehensive and reliable method to determine taxpayer compliance that has been devised and has been able to withstand the test of time over the last thirty years. I urge you to encourage the IRS to continue to make improvements in TCMP where such are appropriate. But I also urge you not to abandon TCMP when no viable alternative has been suggested, tested and agreed upon by all of the interested parties who use its results.

When I served as Commissioner, I was asked repeatedly two questions by taxpayers, the media, and the Congress: (1) what is the level of taxpayer compliance with our tax laws, and (2) how much money are we losing to noncompliance? The ability to provide credible answers to these two questions, in my opinion, is a key to taxpayer confidence in our tax system, and that confidence is essential to the continued viability of our tax system.

For all their faults, the TCMP results permitted me to provide credible answers to those two questions. For one thing, taxpayers could identify with the method for obtaining those results, an IRS audit. The TCMP method was not some abstract statistical, economic or social science theory. Taxpayers could understand the idea of using a statistical sample of in-depth IRS audits to determine the levels of reported and unreported income, of appropriate and inappropriate deductions and credits. Taxpayers also could understand the concept of using the TCMP results to set standards for future selection of returns for audit and to estimate the dollar amount of tax noncompliance by individual taxpayers.

There are many shortcomings of the TCMP. They have been detailed in other testimony and will not be repeated by me here. However, no one has come up with a better overall, comprehensive, credible approach to provide answers to the above two important questions that everyone wants to know about our tax system. And make no mistake abut it, your constituents will want answers to these questions, just as you and your colleagues in Congress will want answers.

From personal experience I can tell you that your predecessors wanted answers to these two questions from me while I was Commissioner. And your predecessors were not satisfied with anecdotal responses, partial results from new and unproven tests, theories about how to improve tax compliance, or promises about what new long-term research studies would eventually provide.

Also make no mistake in believing that your predecessors were unaware of the defects in the TCMP results. On the contrary, the defects were pointed out, often painfully so for me and others at IRS. Promises were made to improve the TCMP, and steps were taken to do so. However, we did not propose to abandon the "known devil" in favor of some "unknown devil."

Yes, the 1994 TCMP will be expensive for the government. In part, however, that is a function of the fact that the new TCMP will provide baseline data for the new approach to the new IRS compliance program called Market Segment Specialization Program, which I believe is the right approach for IRS to be taking in the compliance area. As I understand it, future TCMP-type data will be gathered less expensively.

In part the increased cost of the 1994 TCMP results from an attempt by the IRS to develop data to provide better answers to important questions previously raised by this Subcommittee and others in Congress about the extent of tax compliance under our present system. For example, this Subcommittee over the last several years has held several hearings to discuss the extent of compliance, or noncompliance, by subsidiaries of foreign corporations doing business in the United States. Part of the 1994 TCMP is designed to develop meaningful data to provide better answers to the important questions previously raised by the Subcommittee in that regard.

Yes, TCMP audits involve some additional taxpayer burden. But as a taxpayer who has undergone a TCMP audit previously, I believe the taxpayer burden arguments are overdone, particularly for compliant, well organized taxpayers. IRS takes steps at the beginning of a TCMP audit to minimize the cost and pain of the actual TCMP audit if taxpayers will prepare for the audit by initially organizing their tax information to permit them to more readily answer the auditor's questions. If taxpayers do not do so, or do not have the necessary data to support their income and deductions, then the process can be long and painful, as is usually the case in the normal audit for the same reasons.

Yes, TCMP results are imperfect in determining taxpayer compliance levels and the amount of tax being lost to noncompliance. TCMP certainly does not answer all of the important questions about how to improve taxpayer compliance and minimize noncompliance, and I continue to support the IRS requests for additional appropriated funds (or even the reallocation of existing compliance funds) to support more compliance research. Without a doubt, there is room for continued improvement in all of these areas.

Unless and until a better overall, comprehensive, and credible method to determine and measure tax compliance and the tax gap is developed and tested, I believe it would be a mistake to abandon the TCMP. We can, and should, use the current criticisms to improve the TCMP, but we ought not to abandon it. It may be fashionable at present to simply decide to "start over" when something does not meet our expectations. In the case of the TCMP, I believe to do so would be unwise.

Thank you for inviting me to testify. I will be happy to answer any questions.

Chairman JOHNSON. Thank you, Mr. Gibbs. Dr. Sparrow, welcome.

STATEMENT OF MALCOLM K. SPARROW, PH.D., LECTURER, PUBLIC POLICY, JOHN F. KENNEDY SCHOOL OF GOVERN-MENT, HARVARD UNIVERSITY, CAMBRIDGE, MASS.

Mr. Sparrow. Thank you.

Madam Chairman and members of the subcommittee. I thank you for letting me be a part of this discussion this morning. In some ways, this discussion is part of a broader discussion about the policies of regulatory agencies, and the broader question would be should regulatory agencies be allowed to do random inspections of any kind? Should Customs be allowed to select passengers at random as they come through the airport in their attempts to understand patterns and methods of drug smuggling? Should OSHA inspectors be allowed to show up unannounced at a construction site where there has been no report of hazards, but they go on a random basis just to find out what kind of hazards are there?

I believe that regulatory agencies should be allowed to do random inspections and that it is vital, if they are going to understand patterns of noncompliance. For the last 6 years, I have been studying and writing about some of the changes in the strategies of American regulatory agencies, and there is a very significant move-

ment under way and the IRS is party to that movement.

The movement I think is an attempt to discover a more intelligent, a more analytical approach to identifying patterns of noncompliance and then picking them apart, understanding where they come from and bringing a broad range of different tools to

bear on identified patterns of noncompliance.

At its heart, this strategy is designed to be less coercive, to rely much less on traditional enforcement approaches and to consider, instead, a much broader range of intervention tools, including education, legislative changes, simplification, education programs of various kinds, as well as the normal ragbag of audit and enforcement tools.

Police departments call this problem-solving policing. Environmental protection agencies call it managing for environmental results. OSHA is now calling it the problem-solving approach to hazard mitigation. The IRS calls it their Compliance 2000 strategy.

Now, what is at the heart of the Compliance 2000 strategy, if I understand it correctly, is an intention to develop the capacity to identify important areas of tax noncompliance and then produce tailor-made surgical interventions aimed at producing higher levels of compliance, and to do that problem-area by problem-area. That is the heart of the strategy and it is still under development. It is certainly not fully implemented. It is a much more analytical, more intelligent, and less enforcement oriented approach to taxpayer compliance, which I think we should all recognize and welcome.

But such a strategy depends absolutely on the agency's ability to see clearly patterns of noncompliance and to recognize when they change, and to recognize it sooner, rather than later. An important question to ask is what apparatus is there available to the IRS to enable it to see changing or shifting patterns of noncompliance? I believe that the TCMP instrument itself forms a vital and perhaps indispensable or irreplaceable part of that monitoring apparatus.

The danger the TCMP helps IRS avoid is one that is common to regulatory agencies and to intelligence agencies. Once you start focusing on a particular thing, your belief that that subject area, that problem area is important can become a self-fulfilling prophecy. If you are an intelligence agency and you believe that a particular individual is central in an organization, you then focus more surveillance on that individual. As you do so, you learn more and more about them, and the more you learn about them, the more they appear central in your thinking. It is a self-fulfilling and circular way of doing business.

The danger in regulation or compliance agencies is similar, that you can delude yourself into thinking that you know exactly what these noncompliance problems are, and if you have an idea about what they are, that is what you focus on. Those would be the audits and the examinations that the IRS would conduct. It is quite conceivable that over here on one side, far away from where your sights happen to be trained, new patterns of noncompliance are

emerging of which you are completely oblivious.

Random audits are as unpopular within regulatory agencies as they are outside. Auditors will always tell you that they prefer to be allowed to focus and target their efforts, because they could raise more revenue that way. They are right, they certainly would raise more revenue that way.

But that is not the point. The whole purpose of random audits is that it gives you important information which allows you to do long-range planning and to adjust and redirect your resources over the long term. That is exactly the purpose of the TCMP data. It allows the IRS to adjust their audit selection formulas and target examination and audit resources, and to select enforcement actions that have the greatest impact.

Perhaps one way of looking at this is to remember that the IRS does more than 1 million audits per year which are focused. The critical question is whether those 1 million audits per year are well focused. If they are going to be well focused, what instrumentation and what data is that focusing based on? This is a relatively small number of random audits which helps to ensure that the bulk of the audits are in fact focused on the right people and the right patterns of behavior.

Thank you.

[The prepared statement follows:]

Testimony of:

Dr. Malcolm K. Sparrow

John F. Kennedy School of Government

79 John F. Kennedy Street Cambridge, MA 02138 (Tel: 617-495-8359)

Before:

House Committee on Ways and Means

Subcommittee on Oversight

Date:

Tuesday July 18th 1995

Thank you for the opportunity to address you this morning on the importance of the Taxpayer Compliance Monitoring Program.

For the last six years I have been studying and writing about some very significant changes in the way American regulatory and enforcement agencies approach their business. Many such agencies are rejecting their traditional dependence on predictable processes, procedures, and "coverage", and are developing new capacities for analyzing important patterns of noncompliance, prioritizing risks, and designing intelligent interventions using a much broader range of tools than traditional enforcement actions alone. Police Departments call this emerging strategy "problem-solving policing". Environmental agencies calls it "managing for environmental recults". OSHA now calls it "the problem-solving approach to hazard mitigation". The IRS calls it "compliance 2000".

Under "Compliance 2000" the IRS proposes to develop its capacity for identifying important patterns of tax non-compliance and designing tailor-made, surgical interventions aimed at producing higher levels of compliance, problem area by problem area. That is the heart of their "Compliance 2000" strategy, which is still under development. It is a more analytical, more intelligent, less enforcement-oriented approach to taxpayer compliance; which I think we should all recognize and welcome.

Such a strategy relies absolutely on the agency's ability to recognize quickly, and to see clearly, new patterns of non-compliance as they emerge from time to time. The TCMP forms a vital and, I believe, indispensable part of the monitoring apparatus.

The danger that TCMP helps the IRS avoid is a common one, facing The danger that TCMP helps the IRS avoid is a common one, facing all "compliance" or "regulatory" agencies: namely the risk of assuming that you know about, and can see, all the important patterns of non-compliance. The way these agencies can delude themselves goes something like this. You focus on what you think are the central problems. As you do so, you learn more and more about those problems, and they become yet more central in your thinking. As time passes, you work on the non-compliance problems you know about; and you learn yet more about the non-compliance problems you work on. You can easily get caught in the circularity of this, focusing more and more carefully on things you always focused on before, just because those are the problems that happen to be in your sights. You fish in the are the problems that happen to be in your sights. You fish in the same place, year after year, because that's where you caught fish

before.

Meanwhile new patterns of non-compliance emerge, some geographically concentrated, some peculiar to particular industries, some particular to certain tax-provisions; but all potentially out of your sights. If you have no system or machinery to help you spot new problems, you may not notice them for many years. TCMP is a piece of machinery designed specifically to help identify new areas of non-compliance, which the IRS might otherwise remain oblivious to.

TCMP's strength, I believe, lies in its random selection. (The IRS uses a stratified random sampling technique to make sure that the sample sizes in each area and industry segment are large enough to support proper statistical inferences). The whole point is that the selection is not focused on any existing problem, nor based on any existing IRS biases about where the important problems might be. It is designed as a statistically valid, scientific method of scanning the horizon for new problems. It reveals to the IRS what they don't currently know about patterns of non-compliance.

Random audits are usually as unpopular within a regulatory agency as they are outside. Auditors often think random audits (or "studies") are a waste of time, saying they could raise a lot more revenue if only they were allowed to focus on known problem areas. Which is true; they would raise more revenue that way.

But that argument misses the whole point. The principal value of random audits by the IRS (or--for that matter--random inspections by Customs, or random audits of health care claims) is that they provide information about types of non-compliance which existing targeting strategies might be missing. They provide the opportunity, over the long term, to redirect resources; to adjust audit selection formulas; to target examination and audit resources more effectively; and to select enforcement actions that have the greatest impact on significant areas of non-compliance.

Any cost-benefit analysis of such a program has to weigh the importance of the information about non-compliance trends, which will act as a basis for longer term planning and resource allocation, rather than focusing on the immediate and direct revenue implications.

I understand that undergoing a thorough, line-by-line IRS audit takes some time. I just went through one myself. The IRS plans, I believe, to audit roughly 92,000 individual returns in the proposed TCMP. Given that there are more than 100 million individual filers, and that TCMP comes around no more often than once every three years, this represents a risk of facing a random audit, per taxpayer, per year, of less than 1 in 3,000. This, I believe, is a very small price for taxpayers to pay in exchange for the assurance that the IRS will be able to devote its considerable public resources to the most important non-compliance issues.

I regard TCMP as an essential instrument for monitoring the shifting patterns of non-compliance. Taking it away would blind the IRS to changing patterns of non-compliance.

Chairman JOHNSON. Thank you.

Dr. Sparrow, those 1 million audits that the IRS does, what in-

formation did they turn up about deductions?

Mr. Sparrow. The focused audits do continually provide feedback to the IRS about different forms of noncompliance, as does any focused inspection by a regulatory agency. Whenever you go to delve into one matter believing that you knew what the problem was, you come away a little better educated, and sometimes you will see things that you were not looking for.

But the danger is that, in massive systems such as the IRS, you can completely miss some patterns of noncompliance. There is a feature of tax noncompliance and it is a feature shared with all kinds of other compliance areas that the problems do not reveal

themselves automatically, unless somebody goes—

Chairman JOHNSON. I appreciate that, but I should think the problems like alimony reporting, like the deductions for children, it seems that those might have raised their heads in the million annual audits.

Mr. Sparrow. Yes.

Chairman JOHNSON. Why do they require such an extraordinary effort? First of all, do you know whether they did or did not?

Mr. Sparrow. They do undoubtedly.

Chairman JOHNSON. They come to the agency's attention through

the normal audit course?

Mr. Sparrow. I think it is most unlikely that TCMP would show a form of noncompliance which was totally new and that nobody had ever seen. But I think perhaps its value is in helping you to understand the magnitude and relative importance of different problems.

I can provide an example of an issue that the IRS was well aware of, but did not really understand the magnitude of. I did some work for them on the electronic filing program and the frequency of fraud in that program. They knew that that was a problem and they were detecting a fair number of fraudulent returns coming through that system. But it was not until the 1994 filing season when they actually did a scientifically constructed and statistically valid random sample from which they were able to extrapolate to the whole population that they discovered the size of the problem.

Chairman JOHNSON. So your study of EITC, the earned income tax credit, would be an example of a targeted study that developed

from the normal compliance process, would it not?

Mr. SPARROW. It was different from the TCMP in that it was fo-

cused on one particular kind of return.

Chairman JOHNSON. Last, so I do not keep my colleagues waiting too long, what is your response to the fact that the TCMP did not indicate the widespread abuse occurring under the shelter law?

Mr. SPARROW. I am not familiar with that particular form of non-

compliance.

Chairman JOHNSON. Mr. Gibbs, would you like to comment on

Mr. GIBBS. I guess I would comment this way: I have said before that there are certainly shortcomings and there are certainly deficiencies in any process or procedure. But, Madam Chairman, it is

the best form that we have and I think it is credible.

One of the things that I said in my testimony that I would like to reiterate here, one of the things about the TCMP type approach is that taxpayers across the country can at least understand it. It is not an abstract statistical, it is not an abstract economic, it is not an abstract social science type of theory.

At least at the bottom of it, people can understand and relate to an audit. They can understand and relate to using a bunch of audits as statistical samples on a periodic basis to measure compliance and see how much we are losing. I think that is really important in terms of people understanding and, therefore, having a

method that seems credible across the country.

So almost anything you come up with is going to have short-comings. You can criticize various aspects of it. But if it has a basic ring of truth, until we come up with something that is better, my reaction is it is something that we ought to continue to refine and improve, but we ought not to abandon it. So I would respond to you by saying you may be able to pick at it and show one place where it did not work, one thing that is wrong with it or those types of things. But overall it is better than anything that anyone has proposed as an alternative.

Chairman JOHNSON. Mr. Goldberg.

Mr. GOLDBERG. I am tempted just to rest my case. Madam Chairman, I think that the problem we are having here is TCMP, to the extent what you are saying is random sampling is important, I absolutely agree. To the extent you are saying measures of the tax gap are important, I am not quite as convinced, but that is an OK

thing to do.

My testimony is directed toward the proposed 1994 TCMP. I do not believe that the additional reliability, if any, with respect to tax gap estimates that will come out of that program is worth anything like \$550 million in taxpayer money, more than \$1 billion of out-of-pocket expenses by our citizens, and hundreds of millions of hours of time and torment. I do not think it is worth it. I believe that you can get approximately accurate tax gap estimates far more efficiently and far more effectively in other ways.

Dr. Sparrow referred to circularity. I believe he is describing an important phenomenon, but I believe the circularity is that the IRS for 35 years has been taking these enormous samples and running these so-called TCMP audits on intervals ranging from 3 to 10 years. The circularity is that the IRS is afraid to let go. We have always done this, so we know this is the only way to do it. That

is the circularity.

The IRS, I am absolutely convinced, could accomplish its objectives, could deal with tax gap measures, could deal with detecting trends of noncompliance, could deal with coming up with responsive answers to Members of Congress who are considering anything from EITC compliance legislation to fundamental tax reform through a system that was designed in a fundamentally different fashion. At the end of the day, it will rely on random selection, but you can do a lot better for a lot less. Why not?

Chairman JOHNSON. Certainly the benefit of targeted studies is demonstrated by Dr. Sparrow's really excellent work on the EITC.

I understand the overall logic of the IRS' taxpayer compliance program. It is instructive that it does not touch on the biggest revenue

loss area and that is unreported income.

Is there a program that the IRS could and should be developing to find out how they could better track all the cash economy that the current system is incapable of reaching? This is probably the most important issue that we face right now, because we are about to change our entire Tax Code in part to reach the unreported income.

One does have to question spending \$550 million to refine the structure we have, when one of the reasons for totally changing it is that so many are not complying, and this will not reach them. Now, is there any way we can design a program that might find out how people are avoiding reporting and what can we do about it?

Mr. GOLDBERG. Madam Chairman, with all due respect, I believe that you are going through exactly the process that the Internal Revenue Service should be going through. You have stated a hypothesis. It is correct, in my judgment. Unreported income is the

biggest single problem in the system.

The next question, can we design a research program that will allow us, No. 1, to understand the magnitude of that problem, and, No. 2, design the research program in a way that will give you answers you care about, give you answers that you can do something with. I believe the answer to that question is unambiguously yes, I believe that could be accomplished. I believe it could be both accomplished and educated in a fraction of the time required for TCMP, and I believe that the information you would derive would be far more reliable.

Mr. GIBBONS. Madam Chairman, I would like to respond. It is interesting that you raise that. You are going to have another witness later on in this testimony, Dr. Kent Smith, that was responsible for the largest study I know of on noncompliance in the tax

area. It was sponsored by the American Bar Association.

There have been proposals. There have been a lot of proposals over the last 20 years as to how we detect, what we do to measure, and how we prevent the problems that are going on in the cash economy. This gets back to my fundamental point: To tell me that you will promise me that if I will agree to give up something, you will find something for me that will do this, my reaction is why not give it to me now and let me compare it against what I have before I give it up. Because for the last 20 years, we have not done a very good job. We have known the problem was out there, it has been studied and we still do not have something that people can agree on a broad basis will be appropriate to measure, detect, and prevent the problems in the cash economy.

Mr. GOLDBERG. Madam Chairman, I would just like to point out—and I have not discussed this with Dr. Smith, and I could be mischaracterizing his testimony—I believe his recommendations in essence, at least as I read it, that it may well be prudent to move to far smaller sample sizes and to conduct TCMP examinations on an annual basis. I believe that is also Dr. Scheuren's recommenda-

tion, and it is my recommendation, as well.

Chairman JOHNSON. Thank you.

Mr. GIBBS. Again, Madam Chairman, I just want to make the point that if we can get a consensus, a broad-based consensus about something that is comprehensive and credible, fine. But until we have that, we should not abandon what we have in favor of the pig in the poke.

Chairman JOHNSON. I appreciate your comments, Mr. Gibbs.

Dr. Sparrow.

Mr. Sparrow. Madam Chairman, I think you raise a very important question on the subject of the cash-based businesses, the underground economy, and particularly nonfilers. Central to the Compliance 2000 philosophy is certainly the idea that every kind of noncompliance would be systematically and intelligently studied and then remedies sought. So certainly the IRS should be paying an awful lot of attention to problems that they cannot see through their own internal data.

Now, the specific area that you raise is a very peculiar kind of noncompliance problem. I think nonfilers have always been for many years the IRS' No. 1 compliance problem. If the IRS asked itself what program do we have in place to deal with nonfilers, the answers for many years has been "virtually nothing" because we deal with what comes to us. What data do we have about nonfilers in our data base? Absolutely nothing, not one bit or byte, because they did not file. So this particular problem is an extremely difficult one to get at and to study and requires you to go to outside sources, rather than inside sources.

In looking for signs of concentrations of a cash economy or undeclared income, divide that into two categories: undeclared income and unreported income for people that file and undeclared income for nonfilers. The nonfilers really does require the IRS to go to outside sources of data, just as they would, for instance, have to look at the Yellow Pages of the telephone directory and see which of these businesses that are advertising have not filed and compare that with their own records.

The TCMP data in some sense could help with that form of analysis, though. Suppose you are interested to know what proportion of the jewelry trade in the Los Angeles area did not appear to file tax returns. One way of doing that is to have a representative sample of the ones that did file, to be able to extrapolate by some guess as to how many of them you think there are, and to compare that with external economic indications as to how much revenue this business generates. But it would necessarily have to involve the comparison of internal TCMP data to some other external source which is less traditional for IRS to rely on.

With respect to filers who do not declare their revenue, I just went through a line-by-line IRS audit and was actually quite impressed with the way that it was approached. I had my pile of records on the table, and for at least the first 1½ hours the examiner was not the least bit interested in those. Instead, it was an asset-based approach. She was asking me what I earned, would I show her and tell her about any houses or cars. Then she worked back from that to see whether it appeared to match the income that I had reported.

Even though what she ended up doing was a line-by-line—she wanted to know how I arrived at every figure—there was also room

in the audit for her to notice that my living style might not match what I had declared, and there is that possibility, I believe, even

within the line-by-line direction of the TCMP audits.

Chairman JOHNSON. Thank you. I am sorry that I must excuse myself. I am going to recognize Mr. Laughlin and turn over the gavel to my colleague, Mr. Hancock.

Mr. HANCOCK [presiding]. Mr. Laughlin. Mr. LAUGHLIN. Thank you, Mr. Chairman.

Mr. Goldberg, in your testimony here today, you said there were other far less costly and intrusive ways to develop estimates of at least equal reliability. I first want to ask you what are the intrusive ways that concern you about the TCMP?

Mr. Goldberg. Mr. Laughlin, we are selecting 153,000 citizens, taxpayers, businesses and asking them to provide a line-by-line justification of every item on their return. I can tell you, as a former IRS Commissioner, I can tell you as a practicing attorney, and I can tell you as a citizen, I guarantee you that is very intrusive. That is a miserable experience.

I think that because the government does not have to pay the

freight-

Mr. LAUGHLIN. Because the government does not have to what? Mr. GOLDBERG. Because the government does not have to pay the freight, it is pretty easy to forget what we are doing to the citizen, and that bothers me. It is an intrusive process and I do not think anyone would dispute that.

Mr. LAUGHLIN. I want to ask you from that same testimony if you could identify some less costly methods and intrusive methods

for obtaining the information that is sought.

Mr. GOLDBERG. It depends on which objective. If you are talking about tax gap estimates, people can make tax gap estimates relying on many different data sources. TCMP is a piece of that, but there

are other ways to make those estimates.

I am not a statistician, but, as I mentioned, Dr. Scheuren is, I believe that Dr. Smith is. The experts I talked to when I was the Commissioner led me to conclude that on an all-in basis, the system would be far better served through far smaller samples, orders of magnitude smaller with annual kinds of examinations being conducted. I believe that would be a far more effective approach. The \$550 million of taxpayers' money is a lot, and I am not convinced that the additional accuracy of any TCMP tax gap estimate is worth the cost.

Mr. LAUGHLIN. The reason I ask about the intrusive ways, I have those concerns, too. You stated that you estimate out-of-pocket cost to the taxpayer to be in the \$5,000 to \$10,000 range. My question is what expenses were used in reaching these estimates that you

made?

Mr. GOLDBERG. It was like that. There is no data. All I can tell you is that 60,000 of these audits are going to involve partnerships and corporations, another 50,000 to 60,000 are going to involve taxpayers with schedules C, F, D, and at least in my—I believe those numbers are probably low. But one of the things that I find rather striking is that, in light of all this discussion, I do not believe that the TCMP audit itself even gets information on how much taxpayers spend in the process.

Mr. LAUGHLIN. Certainly, if it gets beyond \$1,000 or so, it certainly takes on the approach of an unfunded mandate that has been on the minds of a lot of Americans the last few years in just dealing with their real property and other activities, so I share the concern that you mention there.

Would you have such a concern on the intrusion to obtain the information, if the IRS were paying the taxpayer for his or her time to come and sit through the compliance audit to determine where

the gaps are?

Mr. GOLDBERG. Well, that would recompense the taxpayer for the out-of-pocket costs. I am not sure it recompenses the taxpayer for the time, the pain, and the suffering But I think that that would

be an important first step to take.

Mr. LAUGHLIN. You have also indicated that nothing new would be learned about the overall tax gap and its major components. The TCMP design calls for measurement of the compliance by market segments. Do you not think that a knowledge of which groups of taxpayers are contributing to the tax gap would be valuable?

Mr. GOLDBERG. I believe that the market segment approach to tax administration is the single most promising development in a decade. I think Dr. Sparrow's reference to Compliance 2000 was an issue I had some involvement with. I think that is breakthrough

progress in tax administration.

What I am saying is that the 1994 TCMP as designed in my judgment is trying to retrofit something to deal with these new issues. I believe you could deal with those new issues far more effectively if you simply say I want to design a program to deal with those new issues. I think we are trying to make something that used to be useful serve a very different purpose, and I do not think they are going to get there as well as they should get there. I agree with market segments, absolutely.

Mr. LAUGHLIN. Thank you very much. Thank you, Mr. Chairman. Mr. HANCOCK. That was an interesting comment you made, compensating the taxpayer for the pain and suffering. I do not know

whether that could be done or not.

Is it possible—and I would like to ask all three this question—we were seriously considering major changes in the tax law in this country, the possibility of a consumption tax or a flat tax. Can we justify the TCMP on a basis of what we do maybe here in the U.S. Congress in the 105th Congress for at least data information, the compliance information on how the existing tax law ought to be changed, or what we need to do if in fact we change it?

Mr. SPARROW. Certainly, if there is a looming and major change in the tax law, then it makes this less attractive at this time right

now, but I would make two qualifying points.

Even if change is coming, then somebody is going to be doing an awful lot of thinking about sensible changes in tax policy, what are the areas of tax administration that cause taxpayers difficulty, which are the areas that are poorly understood, what are the principal forms of noncompliance under the existing system. I do not believe that the IRS, having not done a TCMP survey since 1988, really has up-to-date information of that kind on which it could soundly base recommendations as to tax policy changes.

On the other hand, if there is any doubt at all that major tax changes are coming, if there is a possibility that the tax system remains much as it is for a few more years, then TCMP is urgent. It has not been done since 1988. It is long overdue. It was canceled in 1991, I understand, because of a variety of internal and external objections to it, the normal objections that come any time any regulatory agency does a random inspection of any kind.

All such inspections are intrusive by their nature. Regulatory agencies depend on them absolutely. The fundamental issue here is should regulatory agencies be required to compensate individuals for that necessary intrusion, and should random basis be permitted

as a basis of selection.

Mr. GOLDBERG. Mr. Hancock, as the unnamed Commissioner who was responsible for that heinous act in 1991, I would like to comment, since I was the one responsible for the decision to allegedly cancel the TCMP.

Once again, I believe that random selection of individuals and enterprise for a thorough examination is a necessary component of the tax system. You have got to do it, if you are going to get the

right answers. So I do not dispute that point.

It was not a question of canceling TCMP, shoving our heads in the sand and making light know-nothings. It was saying you can redesign the system, late 20th century statistical techniques, sampling techniques, research techniques, saying that we can do a better job of getting done what we need to get done at the IRS, and

it was not a question of doing nothing.

It was saying go rethink the system, come up with a better design and get it done. I believe the suggestions again of Dr. Scheuren and others who have said far smaller, far more frequent TCMP-like examinations will be less intrusive at the end of the day and provide the government with far more reliable and far more useful information. This program, by its own design, is not going to be materially finished until 1998. If the Congress goes forward with tax reform in 1997, it is a day late and a dollar short.

To the extent, for example, the chairman suggests, issues of cash economy and the underground economy are relevant and that maybe some type of national sales tax or some other low rate of tax would improve compliance, those are important questions. You can only answer those questions through well-designed research programs. Those research programs will necessarily entail as a component some random selection of taxpayer for examination.

But it is not a one-shot 153,000 returns that you are going to do starting for tax year 1994. They are going to be done in 1999, at which point somebody is going to say are we going to do another TCMP, and we are going to say, well, we do not have anything better, we do not know what to do yet, we are dealing with a different system now, we had better do a TCMP, and I suggest that more annual, more focused, far smaller efforts at the end of the day are a better use of the taxpayer's dollar, and by definition less intrusive.

Mr. GIBBS. Mr. Hancock, I would like to respond to this one. For 30 years, we have measured taxpayer noncompliance and compliance in this country and we have estimated the tax gap based on a methodology. That methodology is TCMP. It has grown, it has

changed, it has evolved over that 30-year period. I believe generally, as a methodology for those two purposes, it is accepted by the American public. They understand it and they accept the results.

Now, there are a lot of criticisms that you can raise, and here is my point. My point is, if you are going to postpone it, then before you start saying what we are going to do, we should come up with an alternative. Let us get the alternative and be sure that we have the buy-in from the various constituencies out there that this is going to be as good as or better than what it is that we are aban-

doning.

I think your tie between tax reform that is going to be discussed and this program is an interesting one, because, in effect, what I am suggesting is that we should do the very thing that I applaud the Congress for doing at the present time. We are going to be discussing what the alternative tax systems are. We have proposals up on the table. People are going to know what they are, and then we will see in the final analysis, whether the country agrees to abandon what we have and go to something else or modify it in some way.

If I could answer that, I guess I could answer your question with respect to the cost benefit of the current TCMP. I would make just a practical suggestion to you. I would suggest to you that as we go about talking about something that is going to be far more complex than TCMP, namely a potentially alternative tax system, if we get an awful lot of things held up, not right now, but since 1991, and you put those chips on the table, you are putting an awful lot of pressure on yourselves and on the system in terms of making what seems to me to be a more important choice.

Some have said if you want to drive tax reform, let the TCMP go forward. With all the media publicity and the wailing over the 153,000 taxpayers, maybe that will drive tax reform. My reaction is I would do it for another reason. I would let the system go forward until we make the conscious decision in this country to

change it. That would be my response.

Mr. HANCOCK. Mr. Gibbs, I agree that the principle of the TCMP has probably operated for about 30 years. Thirty years ago, we did not have anything close to the gray areas that we have got now in compliance. When you read in Money Magazine that 50 accountants came up with 50 different conclusions and nobody got it right, you have got a real problem of compliance with the law. Even people who want to comply with it have a problem. What do you do, say I will not take the gray area? Well, you are nuts if you do not take the gray area. Frankly, I think that there are a lot of changes to be made in the internal revenue law without having to completely redo it. However, I am in favor of getting rid of it completely.

Mr. GIBBS. I would simply comment to you that 30 years ago I think this same discussion was held and that was the reason they came up with TCMP. It does give us good data about what we do know. Maybe there are other methods that we should use for things we do not know. But I would not abandon the method for measuring what we do know simply because it is not fulfilling all

of the purposes. Change it, adapt it, make it better, but I would not abandon it.

Mr. HANCOCK. But is it not true that the TCMP only deals with filed returns? It does not take care of the question of nonfilers, and we do not even know what that is. We do not have the vaguest idea of what that is.

Mr. GIBBS. My point 1 minute ago was that we have known about the nonfiling problem for 20 years. What we have not been able to get is a consensus about what type of system is right to measure it, detect it, and then try to do something about it. There have been folks outside the Internal Revenue Service, as well as inside the Internal Revenue Service, working on it.

My only point is do not abandon something that is working for filed returns until you tell me what it is you are going to come up with to deal with the unfiled returns or the unreported income.

Mr. SPARROW. I share your concern about the nonfilers and the failure of TCMP to get at that issue. But nonfilers are at the end of the day only one of scores of identified noncompliance issues, and disbanding with TCMP loses your instrumentation on all of those others. It would be a mistake to do that simply because it did not address one. Rather, I would raise the question, if we have TCMP and that does not address the nonfiler issue, what else do we need to make sure that that particular critical noncompliance area is not forgotten and is properly addressed?

Mr. HANCOCK. Does any witness have any other comment you would like to make?

Mr. Sparrow. It has been very interesting for me to hear Mr. Goldberg's objections to this. He has stated repeatedly that there are alternatives to the random methodology for scanning the horizon for problems that you do not know about. It is true, there are. You can use focus groups and surveys and you can guarantee people anonymity. A lot of researchers at different times have tried to use those tools to get valid and unbiased views of taxpayer behavior. They are notoriously unreliable.

So I am relieved when my friend acknowledges that there is no substitute for randomly selected returns, and that is a fundamental piece of measurement machinery that all regulatory agencies have to have available to them, if they are going to see clearly what issues they are dealing with. That does leave open, though, the question of how big, how often, and whether now is the right time. I understand that those are important critical issues and they are separate from the underlying question of should we allow random audits.

On the question of how big and how often, I would just say in terms of having a sensible data base from which to work, there is now an accumulated deficit of 7 years, with no randomly generated data, and it is urgent that that gap be filled.

Thank you.

Mr. HANCOCK. We just got a call for two 15-minute votes, so we are going to recess this panel and invite the next panel back at 1 o'clock or thereabouts.

Recess

Mr. HANCOCK. Welcome to the subcommittee. Thank you for appearing to testify to the subcommittee on a very important subject.

We will dispense with the preliminaries and get right on to Ms. Smith.

STATEMENT OF VERENDA SMITH, ALEXANDRIA, VA.

Ms. SMITH. Mr. Hancock and subcommittee members, my name is Verenda Smith and I live in Alexandria, Va. I have been asked to share my experience with what I now know is called a TCMP audit.

I have developed a personal definition of adventure. It is something that you wonder if you are going to survive. A TCMP audit is unquestionably an adventure. To understand how the audit affected my life, you have to know about my circumstances at the time.

In the early eighties, I was working as a sports columnist at the Jackson Clarion-Ledger in Jackson, Miss. I earned around \$25,000. I had a few stocks, and I owned a house. My tax situation was fairly simple, but I used a CPA to prepare my return because he had helped me in the year that I had sold a house.

In 1982 I was transferred to Virginia to help launch a new publication called USA Today. I was moving into a 400-square-foot apartment, so most of my belongings went into a storage shed in Jackson.

Now we jump ahead to January 28, 1983. I remember the date clearly, because that was my birthday. Among my birthday cards was a letter from the Internal Revenue Service telling me that I had been selected for an audit which would be at my house in Jackson in about 10 days time.

At that point, I did not know anything about the nature of the audit. I thought all audits were the same, and that if your return was chosen, everything was scrutinized. I thought it was strange that they would want to look at a simple return like mine, especially since I was anything but rich. One thing was clear, though, this was a very extensive audit.

The letter told me that I would need bank statements, documentation to show the source of all my bank deposits, documents to back up every item on the return, and, if I could, would I please

supply a copy of the return itself.

Thankfully, the letter also supplied the name and phone number of my IRS auditor. I called immediately. I am pleased to report that the auditor was great. He seemed to anticipate that I would be confused, surprised and facing difficulties, and he was prepared to help. The reason I can tell this story today and smile is because he understood that I would need my hand held. He used humor and judgment, and he did not treat me like a tax cheat, but, rather, like a taxpayer.

He filled out his questionnaire while we were on the phone, and there were dozens of questions, like what kind of car did I drive and how much cash do I typically carry, questions that seem geared toward determining whether my lifestyle fit my \$25,000 salary. None of the questions were very personal, but some of them

were humorous.

We rescheduled the audit and arranged to have it at his office. My employer invented a business trip to Jackson so I could gather my papers. Had my company been less helpful, that would have

been a most painful expense.

I clearly remember standing outside that storage room looking at a floor-to-ceiling collection of boxes, and I think every one of them was labeled "household stuff." I dug in and eventually toward the back found the box with my old personal records.

That was the easy part. My W-2 and interest statements and so forth were there with the return. But I cannot estimate how many hours I spent pulling together the bank records. I remember the IRS wanted more than 12 months of bank statements. I recall it

covered at least parts of 3 years.

So I had to sort through my checking account records to see how many statements I had in hand. Then I had to go to the bank and order reprints of those I was missing. I had to pay a small fee for each of the statements. Then I had to go through the bank statements and make sure I could defend or explain each deposit. I did not worry over the small \$5 ones, but my travel reimbursements were sometimes substantial. Also, sportswriters often freelance, and I knew I had to show that I declared all my earnings.

I spent at least one afternoon at the newspaper getting copies of my reimbursement records. Eventually, I had everything explained except for one \$1,500 deposit. I could not find any record of where the money had come from. I finally told my accountant that I was worried about it, and he pointed out that it was my tax refund

from the previous year.

I did not have to go to the audit myself. The auditor said my accountant could probably answer all his questions, and this saved me a trip to Jackson. I do not believe I paid the accountant extra. I had paid him to prepare the return, and also I had done all the work in gathering the documentation. But I would have paid him, if necessary, just so I would not have to sit and watch while my financial life was strip-searched.

My accountant called later that day to say that the auditor had seemed pleased with all the documentation and did not think there would be any change to my return. My accountant said this was probably the best audit he had ever participated in. He said the auditor was professional and pleasant and covered the ground

quickly.

A few weeks later, I received this letter in the mail. It said: "We are pleased to tell you that our examination of your tax returns for the above periods shows no change is necessary in your reported tax." Suddenly the whole experience was worth the trouble. I had survived the adventure. But more importantly to me, I had done my part as a citizen of this country. I had filed my return, I had paid the lawful amount of tax and I could prove it.

There have to be audits, and this means that citizens get singled out even if they have done nothing wrong, not unlike jury duty. I hope I never have to do it again. It cost me quite a bit of time and a small amount of money. But I have never been sorry that the

computer spit out my name.

Thank you.

Mr. HANCOCK. Thank you.

Mr. Lane.

STATEMENT OF JOSEPH F. LANE, ENROLLED AGENT, ON BEHALF OF THE NATIONAL ASSOCIATION OF ENROLLED AGENTS

Mr. Lane. Mr. Chairman, my name is Joseph Lane and I am an

enrolled agent in private practice in Menlo Park, Calif.

Thank you for inviting me to testify here today on behalf of the National Association of Enrolled Agents. We have a written statement which we have submitted and I assume it will be in the record. A lot of information has been given already about the historical basis for TCMP, and I will not bother going over that again.

I will go over another taxpayer's reaction to the TCMP which was a little different than Ms. Smith's here today. I had a medical doctor who was a client who went through the last TCMP in 1988. His definition of the process was "an autopsy without benefit of dying." He had his personal income tax returns, his corporate income tax returns, his pension plan returns, and the returns of his

children's trust all examined as part of the TCMP.

He was still amazed about the sheer volume of data that the auditor required and the cost of having representation through the process well exceeded his annual costs. The result of his audit was that all the returns were accepted as filed, but that is scant solace for his lost income for the time away from his practice, the months of responding to ever-increasing demands for more and different information, the stress of being subjected to an IRS probe into all of his financial affairs, and the necessity of having to explain many nontax related transactions to the satisfaction of the examining agent. That last point was particularly vexing to him.

He questioned why he had to explain to the examiner why he refinanced his ski house. He had never deducted any portion of the ski house for his business. It was for the sole use and enjoyment of his family and he felt that it was none of the agent's business.

My explanation that the agent had to account for all deposits into his bank accounts during the period under examination to ensure all income was properly reported merely served to further enrage him that his honesty should be questioned about reporting his business income.

When I recently told him the IRS would be conducting another TCMP this fall his reaction was, in the words of the old Irish bal-

lad, "in the language that the clergy does not know."

I think basically what you have at issue today, is should we conduct TCMPs the way they have been done for the last 30 years or is there a better way? IRS has made a big point over the last 4 or 5 years of reinventing the IRS, and they have reevaluated a lot of the processes they have used over the years and they have modified a substantial number of them.

Our argument is that it might be time to take a look at a different way of looking at this data. There is a cultural change underway within the Service. They have begun to reemphasize traditional methods of auditing with their recent training programs, focusing on economic reality, and they have begun to question the income more than the deductions on tax returns.

While there are legitimate concerns that have been voiced about the wholesale implementation of this economic reality program, you can hardly fault tax administrators for trying to find undisclosed income. It is precisely with respect to identifying undisclosed in-

come where we see the greatest weakness in TCMP.

In a rudimentary sense, conducting a TCMP is akin to "preaching to the choir." It provides data about what taxpayers are deducting. It provides little in the way of identifying income never reflected on the return, and it provides nothing about taxpayers who never file. It is precisely the problem of underreporting and non-reporting of income that so fuels the average taxpayers' frustrations with the current tax system.

Any voluntary compliance system depends on the perception that everyone is paying their fair share. When it becomes common knowledge that there are many members of society not participating, it undermines the support for the system among those who do

comply.

The Service has begun to focus on those segments who are not complying through the use of the market segment specialization program. We believe this approach is a wise one and believe that compliance will result from approaching taxpayers on an industry-

specific basis.

Using a market-driven approach also permits taxpayer education when appropriate, and identifies legislative changes which could increase compliance. The Service clearly recognizes these factors and more and more returns are being selected based on market segment data and not the DIF score.

We think the DIF score will continue to decline as a primary selection mode for the Service, so we question why they have to go

through the traditional way of running a TCMP.

There are many commercial data bases now available which will permit the Service to develop profiles of specific industries and will allow them to target taxpayers who do not meet industry ratios for examination. These external data sources contain management, tax, and financial data which could be factored into a model developed by local DORAs, the District Office Research and Analysis, and lead to more productive audit leads than random selection.

Another example of technology appeared in last Monday's Wall Street Journal where they report that a Halifax, Nova Scotia, accounting professor used something called Benford's Law to identify fraudulent financial transactions by scoring the deviation from a random selection of when numbers appear in a given sequence. The story in the Wall Street Journal indicated that the District Attorney's Office in New York has used this to prosecute fraud. We are not recommending that the IRS adopt this, but it is just an example of where they could take another technique and apply technology a little more efficiently to the process.

We would like to see a cost benefit analysis done of this whole program. I heard today that this is going to cost \$2.1 billion and some 30 or 40 percent of the people selected are going to be innocent bystanders. I think \$2.1 billion could be spent in a much more effective way.

We also would like to see taxpayers compensated for the amount of time it takes and for the cost of representation. I think Mr. Goldberg's projection of \$5,000 to \$10,000 is on the low side for the cost of representation if you are a corporation or a partnership going through this, this type of audit this year.

We would be happy to take any additional questions you have. [The prepared statement follows:]

STATEMENT OF JOSEPH F. LANE, ENROLLED AGENT ON BEHALF OF THE NATIONAL ASSOCIATION OF ENROLLED AGENTS

Madam Chair Johnson, Ranking Member Matsui, members of the Subcommittee on Oversight, my name is Joseph F. Lane and I am an Enrolled Agent in private practice in Menlo Park, California. I thank you for your invitation to testify on behalf of the National Association of Enrolled Agents regarding the Taxpayer Compliance Measurement Programs conducted by the Internal Revenue Service.

I am testifying today on behalf of the 9,000 plus Members of the National Association of Enrolled Agents (NAEA). As the members of the Subcommittee well know, Enrolled Agents are the only tax professionals possessing a Federal license to represent taxpayers before the Internal Revenue Service and our Members represent more than four million (4,000,000) individual and small business taxpayers annually. NAEA is especially appreciative of the interest this Subcommittee has taken in the matter of Internal Revenue Service practices and procedures, and their impact on taxpayers and we pledge our support to further assist the Subcommittee in the future on issues which affect the general taxpaying public.

TCMP: The Historical Perspective

The historical justification for the conduct of Taxpayer Compliance Measurement Programs has been to permit the Internal Revenue Service to hone its selection criteria for tax returns in need of examination. Decades ago when the TCMP was first employed there was ample proof it was needed - the IRS was experiencing a non-change rate between 30% and 40% of returns audited. This, all agreed, was a waste of both the taxpayer's and the Service's time and resources. Over the years the repeated cycle of TCMPs has enabled the Service to increase its ability to forecast which tax returns are more likely to produce a change if examined and they now achieve a no-change rate of approximately 11%.

In addition to reducing non-productive audits another result of using the data gleaned from TCMPs was the fact that the Service could insure some degree of uniformity in the application of enforcement efforts across the country. I remember sitting in the peanut gallery in this very room some twenty-three years ago when I was working at the IRS National Office and listening to then Assistant Commissioner for Examination, Singleton B. Wolfe, state to the Ways and Means Committee that it didn't matter if the taxpayer lived in Augusta, Maine or Augusta, Georgia; they had the same chance of getting audited because of the DIF score process. At that time it was important to reassure taxpayers, and their elected representatives, that there was a uniform application of enforcement across the nation.

It also was a recognition of the fact that there was no other way of approaching the task. The technology to permit more sophisticated data searches was still in its nascent stage. Alternative data bases did not exist to permit the Service to consider other means of devising an audit selection criteria. The computing power of the Service even then was woefully deficient. In short, there was no means other than an intensive, line by line probe into tax returns selected at random. This entailed a great expenditure of staff years on the part of the Service and an uncalculable amount of time, cost and lost opportunities on the part of the taxpayers unlucky enough to get swept up in the TCMP net.

Taxpaver Reaction

Ask any taxpayer who has ever been subjected to a TCMP examination about their experience. I had one client, a medical doctor, define it as "an autopsy without the benefit of dying." He had his personal income tax returns, his corporate income tax returns, his pension plan returns, and the returns of his children's trusts all examined as a part of the last TCMP. He is still amazed about the sheer volume of data the auditor required and the cost of having representation throughout the process well exceeded his usual annual costs for tax and accounting assistance. The result of his audit was that all returns were accepted as filed. But that is scant solace for his lost income for the time away from his practice, the months of responding to ever increasing demands for more and different

information, the stress of being subjected to an IRS probe into all of his financial affairs and the necessity of having to explain many non-tax related transactions to the satisfaction of the examining agent. That last point was particul: 'Iy vexing to my client. He questioned why he had to explain to the examiner why he refinanced his ski house. He never deducted any portion of the ski house for his business. It was for the sole use and enjoyment of his family and he felt it was none of the agent's business. My explanation that the agent had to account for all deposits into his bank accounts during the period under examination to insure that all income was properly reported merely served to further enrage him that his honesty should be questioned about reporting his business income. When I recently told him that the IRS will be conducting another TCMP this Fall his reaction was, in the words of an old Irish ballad, "in a language that the clergy does not know."

The Issue Before Us Today

The issue before us today is to consider if the traditional means of conducting TCMPs are necessary in today's business environment. Do we really need to single out 153,000 taxpayers later this year and subject them to such an invasive process? Are we certain that we can't "reinvent" the TCMP process like so many other processes the IRS has overhauled in the past few years?

There is a cultural change underway within the Internal Revenue Service. They have begun to re-emphasize the traditional methods of auditing with their recent training programs focusing on the economic reality of the taxpayer's lifestyle if it is inconsistent with the income level reflected on the tax return. This reflects the effort to question not only deductions the taxpayer has taken but the income received and reported. While there have been legitimate concerns raised about any wholesale implementation of this approach, one can hardly fault tax administrators for attempting to identify taxpayers with undisclosed income.

It is precisely with respect to this last point, identifying undisclosed income, where we see the greatest weakness of the TCMP process. In a rudimentary sense, conducting a TCMP is akin to "preaching to the choir." It provides data about what compliant taxpayers are deducting. It provides little in the way of identifying income never reflected on the return and it provides nothing about taxpayers who never file. It is precisely the problem of under-reporting and non-reporting of income that so fuels the average taxpayer's frustration with the current tax system. Any voluntary compliance system depends on the perception that everyone is paying their fair share. When it becomes common knowledge that there are many members of the society not participating in the system, it undermines the support for the system among those who do comply.

The Service has begun to focus on those segments who are not complying through the use of the Market Segment Specialization Program. We believe this approach is a wise one and believe that compliance will result from approaching taxpayers on an industry specific basis. Using a market driven approach also permits taxpayer education when appropriate and identifies legislative changes which could increase compliance. The Service clearly recognizes these factors and therefore an increasing number of returns selected for examination are not being selected based on DIF formulas but because the taxpayer is in a particular industry or fits a market segment profile. The Service has seen the dramatic results of many of these market segment audit programs in the form of higher deficiency amounts and increasing market sector compliance levels.

We believe that the DIF score will continue to decline as the primary selection mode as the Service develops more market segment data and begins to reprogram its resources into more productive examination areas. It is less and less important to maintain consistency in examination approaches throughout the country as our business environment and enterprises are increasingly specialized and dispersed geographically. For example, what does it matter to the Gulf States District headquartered in New Orleans if the Los Angeles District has a team assigned to the entertainment industry?

There are many commercial data bases now available which would permit the Service to develop macro-economic profiles of specific industries for purposes of targeting taxpayers who do not meet industry ratios for examination. These external data sources contain management, tax and financial data which could be factored into a model developed by the local District Office Research and Analysis (DORA) teams and lead to much more productive audit leads than random selection. In addition, the benefit of not putting taxpayers who are complying through the agony of the process needlessly would accrue to the Service's credit.

We believe that additional focus should be given to using technology in identifying targets for examination. By way of illustration, an article appeared in the Wall Street Journal on July 10, 1995 (page B1) which discussed the process an accounting professor in Halifax, Nova Scotia is using to help identify tax cheating and other financial fraud. He uses an obscure numerology theory known as Benford's Law, which lays out the statistical frequency with which the numbers 1 through 9 appear in any set of random numbers. The law is applied to suspicious checks or tax returns to see if the numbers are truly random or invented. This process has been employed by the District Attorney in Brooklyn, NY in prosecuting check fraud in seven companies and the professor consults with Canadian and other taxing authorities. I discussed the applicability of this law to tax auditing with an accounting professor colleague this past week and he agreed that for certain tax schedules, like Schedules C or F or E, the theory should be predictive. He pointed out however, that wage data and charitable contributions would not work because one is more likely to find numbers ending in 0 or 5 in these two categories than a random sample would have predicted. We are not recommending that the Service adopt this procedure but use it merely to illustrate that there are alternative ways of approaching issues we used to depend on manual processes to accomplish.

Recommendations

We would like to see a true cost benefit analysis of the current plan for the upcoming TCMP. It should include some approximation of the cost to taxpayers to participate in this statistical-gathering exercise as well as the staff years and resources of the Service. The true cost should then be compared with alternative ways of gathering data using commercially available business resources, such as Dun & Bradstreet, SRIs Values and Lifestyles Studies, etc.

We would like to see taxpayers who are subjected to a TCMP compensated for the cost of their participation. We are aware that this has been discussed before and that some Service officials have expressed some support for compensating taxpayers who emerge from the process with a no-change. We are concerned that this would provide incentive for agents to find some issue to disagree on just to escape the reimbursement process. In principle, we would like to see all taxpayers receive some compensation for their involvement since their inclusion was based on a random selection and not the result of any indication that they deserved to be audited. Of course, we can understand the Service's position that this would have to balanced against the results of the examination. We can well imagine the Service balking at the prospect of compensating someone who they are in the process of criminally prosecuting. Perhaps the remedy is to compensate up to a certain level of proposed deficiency only. We would like to see further study of this proposal.

Closing

We appreciate the opportunity to offer our comments about the Taxpayer Compliance Measurement Program. We offer our assistance to provide any additional information raised by these comments or other areas of concern.

Mr. HANCOCK. Thank you for your testimony. All three of your written statements will be entered into the record.
Mr. Keating.

STATEMENT OF DAVID L. KEATING, PRESIDENT, NATIONAL TAXPAYERS UNION FOUNDATION

Mr. KEATING. I appreciate the opportunity to testify today. I represent the National Taxpayers Union Foundation. My name is David Keating. I would like to touch on something not yet heard in today's hearing that I picked up from our advisors when I canvassed them for suggestions about this program. That is, does the TCMP have a garbage-in/garbage-out problem, and how serious is it?

A recent article in Tax Notes, by George Guttman—who I believe is in the audience—says TCMP data reflects selected audit results only, and no subsequent change is made when a taxpayer successfully contests an adjustment with the IRS appeals office or through litigation. Overall, the maintenance rate for issues that go to appeals and litigation is no more than 50 cents on the dollar.

Something else that I learned that was quite disturbing to me is that the people in the appeals office have, I think, different standards that they are held to than the tax auditors. If you look at rule one, governing practice before the appeals office, it says, "It shall be his or her duty"—meaning an appeals officer—"to determine the correct amount of tax with strict impartiality as between the tax-payer and the government and without favoritism or discrimination as between taxpayers."

Now, given the enormous amount of criticism of tax auditors by GAO and others, and the discrepancy between findings at the auditing level and the appeals level, I wonder how much statistical noise we are introducing into the TCMP data by not holding these auditors to the guidelines or professional standards we expect for

employees of the appeals office.

I also picked up concerns about the timing of this TCMP. You would have to have your head buried in the sand not to realize that politically a lot of changes have happened in the last few months, and I think there is probably the best chance we have ever seen since the adoption of the income tax, over 80 years ago, to actually replace it with something brand new.

The IRS is essentially proposing to put all its statistical eggs in one basket, meaning the 1994 return, which may be one of the last returns under the current income tax law. I would think they

would want to put their eggs in more baskets.

Another thing that is very important to our members and others is that it can be extremely expensive to face a TCMP audit. For a small businessperson, the cost can be quite punitive. I notice that in some of the stratifications of the samples, it would not be uncommon for 1 in 100 or even 1 in 200 taxpayers in some small business areas to be selected for audit under TCMP. That is a rather large number of people, especially when you compare it to other auditing rates in the population.

Now, the IRS in designing this TCMP project is pretending there is no cost for the taxpayer's time and expense in hiring a professional. That is uneconomic for the country. The IRS has little in-

centive to make the TCMP process more efficient because it has ignored the value of the taxpayer's time and expense in designing

this program.

It should be of little surprise that the IRS has not given proper weight to those costs in designing this particular TCMP. When public opinion pollsters, when they want to go into a lengthy examination—and one of the big problems public opinion pollsters are finding today is getting people to cooperate—where they want to do more detailed multihour focus group they have to pay people in order to get them to attend.

What we have here is the IRS is going to conduct the Nation's most tedious and expensive focus group, but instead of paying the people to participate they are actually going to force them to pay hundreds or thousands or tens of thousands of dollars for the ordeal, and that does not even count the potential tax that may be

collected.

We believe that if the IRS thinks that gathering this data is so important, then it should pay taxpayers for the time and expense of submitting to such a TCMP audit. This will give the agency an incentive to design a TCMP survey that efficiently considers the use of all national resources, not just the agency funds.

I would also like to briefly express some concern about the use of the TCMP data by the IRS and the Congress. We cannot think of a single instance since 1986 where the IRS has made a single

legislative proposal based on the last TCMP survey.

Even though everyone knows there is a problem with EITC, the IRS actually sent out EITC refunds to taxpayers who did not even

qualify for the program.

In conclusion, we think that before undertaking another TCMP, especially the one that is going to be the largest ever, the IRS should be required to study other less intrusive alternatives. The TCMP, as it presently exists, is overly burdensome on taxpayers and arbitrary in the selection process.

By the time meaningful results can be derived from this program, the information that will be gathered may well be obsolete

or irrelevant by the passage of comprehensive tax reform.

Thank you very much.

[The prepared statement follows:]

Statement of

David L. Keating
President
National Taxpayers Union Foundation

on the

Taxpayer Compliance Measurement Program

before the

Subcommittee on Oversight Committee on Ways & Means U.S. House of Representatives

July 18, 1995

Thank you for the opportunity to testify on the Taxpaye: Compliance Measurement Program (TCMP). National Taxpayers Union Foundation represents 300,000 members who are concerned about the fairness of the tax audit and collection process.

Representative Johnson, we commend you for scheduling this hearing to examine the proposed 1994 Taxpayer Compliance Measurement Program. As you know, the upcoming TCMP is scheduled to review 153,000 returns, substantially more than previous TCMP surveys.

As I worked to prepare this statement, I sought comments from several professional tax practitioners who are informal advisors to our organization. I am especially indebted to Kip Dellinger, who is a partner at Dellinger & O'Connell, a Los Angeles based CPA firm.

Writing in the June 5, 1995 <u>Tax Notes</u>, George Guttman reports that the next "TCMP is expected to cost approximately \$280 million in FY 1996 and require 4,388 staff years. This will break down to 4,248 revenue agent staff years, or 26 percent of agent resources, and 140 tax auditor staff years, or 5 percent of auditor resources." Not counted in the IRS' cost estimates, of course, is the value of the time spent by taxpayers and their tax professionals. Given the rigorous nature of a TCMP audit, these costs are likely to be even larger for the taxpayer.

Please keep in mind how arduous a TCMP audit is. How many of the married members of this subcommittee can quickly locate their marriage license? Remember, that is just the first item on the tax return, and is one of the easiest to document. If the IRS reviews all the deposits made in your various banking, checking, or mutual fund accounts, how easy would it be for you to document the source of all funds deposited and transferred?

Does TCMP have a garbage-in, garbage-out problem?

Guttman notes that "TCMP data reflects selected audit results only. No subsequent TCMP change is made when a taxpayer successfully contests an adjustment with the IRS Appeals Office or through litigation. Overall, the sustension rate for issues that go to Appeals or Litigation is no more than 50 cents or less on the dollar."

Essentially this means that the TCMP data can be used to flag tax returns where the IRS can claim a tax adjustment, not whether it can win such an adjustment. Given recent GAO criticisms of the knowledge of tax laws by tax auditors, this would seem to call into question the reliability of the raw TCMP data.

A recent paper by Dan Pilla for the Cato Institute notes the different standards between the auditing process and the cases reviewed by the Appeals Division. He notes that "of the cases received by the Appeals Division in 1993, nearly 97 percent were settled by agreement. That is to say, while the taxpayer was unable to reach a satisfactory settlement with the tax auditor, he could with an Appeals officer 97 percent of the time." Pilla says the reason why taxpayers often come to an agreement with an Appeals officer "is found in the rules governing practice before the Appeals office." Pilla quotes the language of Rule 1:

"An exaction by the U.S. Government which is not based upon law, statutory or otherwise, is a taking of property without due process of law, in violation of the Fifth Amendment to the U.S. Constitution.

Accordingly, an Appeals representative in his conclusion of fact or supplications of the law, shall hew to the law and the recognized standards of legal construction. It shall be his or her duty to determine the correct amount of the tax, with strict impartiality as between the taxpayer and the Government, and without favoritism or discrimination as between taxpayers."

Pilla notes that "incredibly, no similar guidelines exist for tax auditors." In other words, the people who will be compiling data for the TCMP are not operating under rules requiring the type of strict impartiality that is the standard for the Appeals Division.

The timing of this TCMP is poor.

We believe that there is a very good chance that the next Congress will pass fundamental reform of the current income tax law. The current income tax may be replaced altogether by a national sales or flat rate tax. Both the House Majority and Minority leaders have proposed a fundamental restructuring of the tax laws as have the chairmen of the Ways & Means and Senate Budget committees. With the likelihood that the tax laws will be fundamentally restructured, and soon, the timing of this TCMP is questionable at best.

TCMP is overly burdensome on and costly for arbitrarily selected taxpayers.

As described by the IRS, taxpayers are selected for TCMP audits on a random basis within stratified taxpayer filing groups. Yet these taxpayers are subjected to what can become an enormously time consuming and costly audit process. It takes an enormous amount of time to assemble the documentation of every line item on a tax return. In many cases, it is necessary for the taxpayer to retain a professional for representation. In other instances, taxpayers do so simply out of fear, or in response to the overwhelming and intimidating information requests that accompany TCMP examinations.

Because of the nature and extent of TCMP examinations, professional fees can be extremely expensive and will generally exceed the cost of preparation of the returns themselves several fold. While a \$280 million program is, by federal government standards, a paltry expense — the costs of a TCMP to individual taxpayers or small businesses can become almost punitive.

When so many other methods, resource, and tools are available in the IRS arsenal of weapons to be used against errant taxpayers, it is patently unfair to put a random group of taxpayers through the rigorous, sometimes ridiculous and very expensive process that TCMP entails for statistical purposes.

TCMP design should account for all costs, and taxpayers should be compensated.

To the extent that the IRS is allowed to proceed with the presently contemplated TCMP program — the government should be required to compensate both taxpayers and any professional representatives they engage for their time and effort. Care should be taken to advise taxpayers selected for a TCMP that they will be compensated for their time and that if they choose to retain a professional representative they will be reimbursed for reasonable professional advisors' fees.

In designing this TCMP and projecting its cost, the IRS is pretending that there is no cost for the taxpayer's time and the expense of hiring a professional. That is unwise and uneconomic for the country.

Guttman's article notes that statistician Amir Aczel "contends that the DIF [discriminate function] analysis has been superseded by more powerful statistical methods, such as 'logistic regression,' which requires less data. Aczel claims 20,000 audits can provide the same type of information that the IRS will get from the 153,000 plan for the 1994 TCMP." Guttman reports that "Aczel says the IRS' plan for the next TCMP is like doing exploratory surgery with stone-age tools."

Guttman also cites "Don Rubin, chairman of the Statistics Department at Harvard University [who] argues that nobody knows whether Aczel is right." He writes that Rubin believes "the best that an outside statistician can say is that the IRS approach can be made more efficient."

Yet the IRS has little incentive to make the process more efficient because it has ignored the value of taxpayers' time and expense. It should come as no surprise that the IRS has developed a TCMP that statisticians think can be made more efficient, since most of the expense would be borne by the unlucky taxpayers who will be selected for this arduous audit.

When public opinion pollsters wish to conduct a lengthy examination of public attitudes, they rely on focus groups. In order to get people to attend focus groups they pay them. This enables the public opinion professional to secure a representative sample of people who are willing to give up several hours of their time to answer questions and react to proposals.

The IRS is proposing to conduct perhaps the nation's most tedious and expensive focus group. But instead of the IRS paying the survey participants, the subject must participate at no charge. Indeed most will probably pay a tax professional hundreds or thousands of dollars for assistance with this ordeal. And don't forget that the taxpayer may have to fork over even more taxes or spend thousands of dollars to appeal a decision by a tax auditor who is unfamiliar with the tax law and has recommended an incorrect claim for additional tax.

If the IRS believes gathering this data is so important, it should pay taxpayers for their time and expense of submitting to the audit. This will give the agency an incentive to design a TCMP survey that efficiently considers the use of all national resources, not just agency funds.

Reimbursement should not be based on the results of the examination; it should be based on some multiple of the hours spent by the IRS in completing the TCMP exam (including pre-audit, review and supervisory time). For example, for every hour spent by the IRS, the taxpayer and representative should be reimbursed for two hours. The "rate" of reimbursement could be based on the prevailing rate in the local area for professional representation.

While some may argue that taxpayers whose exams render a sizable deficiency and substantial non-compliance should bear the cost of their examinations, this will only serve to encourage some at the IRS to assume overly aggressive positions with respect to potential adjustments.

The Service's Arsenal of Weapons has vastly expanded.

When originally conceived, the TCMP was likely the only method realistically available to determine the level of taxpayer compliance that the program was designed to assess. At the time it was initially developed and implemented, the collective resources available to the Internal Revenue Service to obtain the type of information with respect to various categories of taxpayers and their varying degrees of compliance with our income tax laws were far more limited than the resources available today. Moreover, compliance with the overwhelming technical and mechanical requirements of the tax law was far less burdensome than that faced by taxpayers today and, consequently, the time and effort — as well as likely professional fees — were less than what faces potential TCMP targets today.

Today, the IRS has access to a wealth of information -- over a billion information documents per year -- that can lend itself to the kind of statistical analysis that is developed by the TCMP. This includes the ability to more thoroughly analyze (both quantitatively and qualitatively) the results of the ongoing, regular examination process. And it becomes readily apparent when one examines the characteristics, methods and objectives of the IRS's "economic reality" audit approach.

We have previously expressed our concern about privacy issues related to the "economic reality" examination approach. Nonetheless, the mere fact this information is available, that the IRS has access to data bases and taxpayer information infinitely greater than when the TCMP was conceived, should have reduced the need for an arbitrary examination process as intrusive as TCMP. In addition, the IRS has and can continue to focus on particular types of deductions or other tax information on a targeted basis. This information is often developed by region and income level and probably provides more significant and timely information than what results following the years of accumulation and interpretation of TCMP results.

We also call the Committee's attention to the increased specialized knowledge that the IRS has developed largely without use of TCMP results as evidenced by the Market Segment Specialization and Industry Specialization Programs.

Relevance of the data obtained in TCMP is questionable.

We cannot think of a single instance since 1986 where the IRS has made a legislative proposal based on the most recent TCMP survey. There is clearly an enormous problem with earned income tax credit (EITC) compliance, yet after the latest TCMP, the IRS sent out EITC refunds to taxpayers who didn't qualify for the program! The IRS made no attempt to recover this money. EITC has also been an area rife with fraud.

The Administration and the IRS have failed to identify legislative initiatives to improve EITC compliance, and the Administration pushed through legislative changes in 1993 to make the program more generous.

IRS spokesman, Steve Pyrek, has stated that the TCMP is "... only done sporadically because it's very expensive and time-consuming People are doing things now and living in ways they weren't five years ago As economic life changes we need to keep up with those changes and with what's going on in society."

Mr. Pyrek has a point. But based on experience, we doubt that the TCMP will accomplish what he describes as the IRS goals and objectives for the TCMP.

First, the economic and lifestyle changes that Mr. Pyrek describes — particularly with regard to monetary matters — are accelerating as electronic information technology plays a more important role in our economic system.

This Committee's own Press Release announcing this Hearing highlights the fact that Congress has not yet received reports on the findings of overall compliance from the 1985 and 1988 TCMP surveys. Clearly, delays of any measurable time period in obtaining whatever results derive from the proposed 1994 TCMP audits would render those results, at best, of diminished usefulness and, perhaps ... meaningless. This is further magnified by the obvious overwhelming public support and Congressional interest in a very significant revision of our national tax structure. To arbitrarily subject 153,000 taxpayers or entities to the costs and burdens of this program seems on the whole, misplaced.

Second, the use of 280 million dollars of IRS resources to derive detailed information from a population of Americans that do — in fact — file income tax returns when much of that information is available by other means appears to be a colossal misuse of taxpayer dollars.

Third, before undertaking another TCMP, the IRS should be required to study other, less intrusive, alternatives that will provide more timely information. There remains the unanswered question whether yet another TCMP is underway because of a bureaucratic mindset that says — "that's the way we've always done things." For example, the IRS should consider looking at fewer items on more returns, rather than every single item on every return selected for a TCMP audit. By looking at fewer items on more returns, this would at least spread out the burden somewhat so that the TCMP compliance burden is allocated somewhat more fairly.

Also, some members of the practitioner community believe that the IRS sees the TCMP program and its attendant publicity as a form of deterrent. We do not believe that to be the case.

Conclusion

The TCMP program, as it presently exists, is overly burdensome on taxpayers and arbitrary in the selection process. Much of the information the program attempts to garner can be secured by alternative means. Moreover, by the time meaningful results can be derived from the program, the information will almost surely be rendered obsolete or irrelevant by today's rapidly changing information society or passage of comprehensive tax reform. We hope that the IRS uses its resources on projects more likely to improve taxpayer service.

Mr. HANCOCK. Thank you all for your testimony. There are a few questions that we would like to get in the record, and I have got a lot of questions about this. But in the interest of time, Ms. Smith, from your testimony I kind of get the impression that you feel that this just basically is the price of citizenship.

Ms. SMITH. Very much so. That is how I was raised and it is a theory that I have come to embrace myself. That is not to say that I did not think it was the audit from hell or that I want to do it

again. [Laughter.]

Mr. HANCOCK. Kind of like a root canal?

Ms. SMITH. I, given a choice between this and a root canal, I

would take the root canal, I think. I have had one of each.

But, yes, it is important to me to pay my taxes, to do it correctly as best I can and to participate in the system. It was not my judgment and nobody asked me in 1981 if this was the best way for the IRS to do its business, they just said this is what we are doing and you are in it, and I was glad to participate.

Mr. HANCOCK. Well, do you think that you should have been re-

imbursed for your expenses?

Ms. SMITH. I do not think there is enough money to reimburse anybody for the kind of time and stress that it puts you through. But having thought about this question in the past week, I think it would have been nice if I had had, for instance, a voucher that would have given me one-half hour of some CPA's time for a consultation, something like that. Perhaps, even something to show appreciation like a method of filing electronically for free for the next 5 years, would have been nice. Not unlike what Nielsen did when they asked me to write down a television log for a week.

Mr. HANCOCK. Well, what would have been your attitude if, in fact, they had said, yes, you got a trip back to Jackson for this

audit.

Ms. SMITH. I do not believe I was given any choice. The records were my responsibility and it had been my decision to leave the records. I never thought about going into an audit. I just was moving and left the records behind because I did not think I would ever need them again. I did have the forethought to keep them, thank goodness.

If I had had to make some arrangements to go back and get them I would probably have had friends of mine dig out the boxes

and try to do something that I could afford to do.

Mr. HANCOCK. It could have been a little bit different, though,

if, in fact, you had been out several thousand dollars?

Ms. SMITH. Oh, yes. Everybody's circumstances would be different. If this had happened to my mother it would have been a disaster.

Mr. HANCOCK. Mr. Lane, you indicate, in your testimony, that there is value in focusing on the economic reality of the taxpayer's lifestyle if it is inconsistent with the income, the level reflected on the return.

Does this not raise your concern that the TCMP process does lit-

tle to identify income not reflected on the return?

Mr. LANE. Yes. It does address our concern. We are concerned that since TCMP just applys to taxpayers who file, there ought to be better systems devised to identify taxpayers who are not filing

at all. There are data bases out there that the Service could access, commercial data bases which would give them participants in given industries.

For example, what they are doing in the market segments approach is a much more realistic and much more profitable approach in terms of the use of their resources than to go out and spend \$2.1 billion on this TCMP that is going to drag 40 percent of taxpayers

in and result in refunds, or no changes.

In addition, the cost to the taxpayers and small businesspeople to comply with this TCMP is just enormous. The testimony we had this morning by Mr. Brand of about 1 hour or 1½ hours per audit, that may be what the national office thinks happens, but in reality what happens in the field is different. The taxpayer that Mr. Zimmer described that would be assigned to a fairly low-graded auditor and the fact that the TCMP is given such an emphasis within the Service—plus the fact that they have all gone through this economic reality training this year, that taxpayer who walked in and refused to turn over the records of a noninterest bearing account would be treated like Al Capone.

There is no question that the auditor would get a summons issued for the checking account data and there is no way, under any circumstances, that it would be a 1½-hour audit. I can assure you

of that.

It would turn into a major controversy with that taxpayer. There is no way, in a TCMP especially that you are going to tell some tax auditor you are not going to give him the information on the bank account. The first request the taxpayer got notifying him would have told him to bring in all of his bank statements for the year.

That is just the reality. So I do not know what the national office thinks is happening out there, but what is actually happening on the street is that they would treat that a lot differently. It would be a much more thorough audit if the taxpayer did not provide all of the data that was requested in the information document re-

auest.

Mr. Hancock. Well, do you think that even on the TCMP you did not get the idea of assumption there, the assumption of guilt, something being wrong. But in your judgment, especially with the way some of these audits have been handled that you are familiar with, that there is an assumption on the part of the auditor that, in fact, there has been something wrong, rather than just saying, look we are running a compliance check here.

Mr. Lane. TCMP gets two reactions in the field. The experienced revenue agents generally consider it a nuisance because it is a random sample and they know, therefore, that some of these people are going to be refunds or no changes. Their attitude is it is a waste of time. We ought to audit people that we know we can identify through some other vehicle that are a lot more likely to result

in audit changes, higher DIF scores for example.

Newer agents, and there are a lot of new agents out there, have not been through a TCMP before and they see the emphasis the Service gives it. They see things like congressional hearings and newspaper articles on it and they take away a frame of reference that this is a really hot issue. They get special reports they have to fill out and there are special detailed forms, so the impression it creates for the newer agents is that this is a very highly rated and important program. So they tend to approach it much less flexibly than a normal audit.

They are given marching orders by their superiors that they have to audit every single line on the return and if there are any related entities, they have to consider which related entities will also be opened for exam. This is a much different environment than a normal audit where a fair amount is left to their discretion.

So it signals to the employees that this is a fairly important program and so they are less flexible with the taxpayer as a result.

Mr. HANCOCK. In the preparation of the cost benefit analysis. how would you recommend that they can reduce the cost to the tax-

payers for a TCMP audit?

Mr. LANE. Well, one of our recommendations is that IRS take notice that there are a lot of commercial data bases available. Just to name a few, the Stanford Research Institute has a program called the Values and Lifestyle Study. They have been gathering data for 30 years now. If I am Procter & Gamble and I want to know households that have \$100,000 and more in income, and have a Cadillac in the garage that is less than 2 years old, I can buy a list of people that fit the criterion. I can custom design these lists for marketing.

Our analysis is that before we'd go and spend \$2.1 billion of the taxpayers' money which is the true cost of this TCMP—the lost opportunity costs of those agents in the field and \$559 million of the program, itself—I would want to take a look at whether there is alternative data that is already existing out there in Dun and Bradstreet, and every place else in the world that you can buy.

I think there is no argument from the Service officials, if there are any left in the room or the ones that were here this morning, that the market segment approach is one of the best things they have come up with in tax administration in the last 25 years.

They can prove it by two trends. No. 1, the average deficiency on a market-segment audit is significantly higher than the average deficiency in a general program audit. No. 2, statistics reflect increasing compliance levels in given market segments once they have

So why not focus your efforts, your money, and your resources on market segments and identify more and more of those people who are not complying and get those market segments into compliance.

I would try to buy these commercially available data bases. Now, someone earlier, when we were talking on the break, indicated that some of these companies would not sell the data to the IRS, and that may be the case, I do not know. I am not a statistician; nor do I go out and try to purchase these things. But I know they are available.

Mr. HANCOCK. Thank you.

Mr. Keating, you expressed in your testimony that the timing of this TCMP is poor as a result of possible major changes in the current income tax law. Do you believe that there are aspects of the current laws that may be important for the administration of future laws under tax reform, for instance the reporting of income or the timely payment of taxes?

Mr. KEATING. Well, I suppose it depends on what we ultimately come up with as a part of tax reform. But certainly it is quite possible, especially on the definition of income including how much income is reported and whether it is accurately reported, that the TCMP can provide information that is applicable for current or future tax administration.

Mr. HANCOCK. How would you recommend that this information be gathered on the current behavior pattern of taxpayers relevant

to the existing law?

Mr. KEATING. I do not know enough about the statistical development of TCMP to say for sure, but I am sure of one thing. When you prepare your tax return or when someone is auditing the tax return, the law as it exists now is so complicated that there is a huge potential variation in what an expert would say is the proper amount of tax that is actually due.

You referred, earlier in the hearing, to the Money Magazine report, where they had 50 professionals look at the same theoretical tax return and they came up with 50 different answers. Those are the kinds of problems we are facing with the Tax Code today—an incredibly complex tax law that is difficult not only for the tax-

payer to comply with but the Service to administer.

Those are problems that I would imagine the TCMP process has

a great deal of difficulty with as well.

Mr. HANCOCK. Well, you spoke about the IRS having access to all kinds of information, data bases, Mr. Lane mentioned it, Dun and Bradstreet reports, and all that type of taxpayer information.

Do you support the idea of IRS using these external data bases,

as Mr. Lane suggested? Would you support that?

Mr. KEATING. I doubt it. I think it is probably a nonissue anyway because the firms that compile these data bases, much of them are direct marketing oriented firms and they are not going to want this data being used for tax administration. If they do allow IRS access to the data, the people that compile it probably think that a lot of the data that they are able to get now on a voluntary basis from people will not be forthcoming, because they think it might be used for tax administration or auditing.

So I do not think the direct marketing community or industry would ever allow this data to be sold to the IRS. In fact, in previous times when the IRS tried to obtain samples of demographic data from the industry, I recall a great deal of resistance to this.

I think the industry will continue to resist and do so successfully.

Mr. HANCOCK. Thank you.

Mr. Portman.

Mr. PORTMAN. Thank you, Mr. Chairman.

First of all I want to apologize for not being here through your testimony. As our chairman has probably explained, our schedule is crazy these days. We have a lot of conflicting scheduling items, and I just apologize to those who are here today that we all cannot be here more.

I have read through the testimony. I have not read every word of it, but I have skimmed all the testimony that I received and I appreciated all of your views. Mr. Lane, it is good to have you back before the subcommittee again.

Mr. LANE. Thank you.

Mr. PORTMAN. I like your candid approach to this. I would agree with you on the market segment data, not just because Procter & Gamble is in my district, but because, in fact, as I tried to articulate earlier, I think there is a lot of new technology and new techniques to get at some of the same information the IRS is rightfully looking for in this latest program.

So I would hope, too, that perhaps we could utilize some of that

private sector data that is already out there.

Let me ask you another question in your role as representing the enrolled agents. Perhaps it is something that the IRS officially must address, but do you understand how the burden of proof is going to work? Let us say that someone, like Ms. Smith, makes a claim about her lifestyle in connection with the economic reality approach. It cannot be sustained. Either you have lost your marriage license or you know you do not have a title for the riding lawnmower that you bought 2 years ago, or you got from a friend or traded with your neighbor, or whatever it is.

How does the burden of proof change, if at all, as compared to a normal audit? Do you understand how that is going to work?

Mr. LANE. Yes, I do. There is no change in the burden of proof in this instance because it is a civil examination and the burden

of proof is with the taxpayer not with the Service.

Mr. PORTMAN. OK. So she has to prove that she did not do something, even if she does not have the information on hand. That sort of is a transition to the appeals process and you talked a little in your testimony, I think, about the fact that 97 percent of the cases that go to appeal are resolved. What happens to those? Are the adjustments made pursuant to the IRS or their estimate? When you say they are resolved, what is the typical outcome, do you know?

Mr. KEATING. Well, according to George Guttman's article in Tax Notes, the overall sustention rate for issues that go to appeals or litigation is more than 50 cents on the dollar. The taxpayers and the IRS are able to reach agreement in 97 percent of the cases that

go to an appeals officer.

I think that is probably because No. 1, the level of standards and professionalism at the appeals process is probably higher than at the auditing process. No. 2, there is probably also better knowledge of the tax law and better understanding of the hazards of litigation, both for the IRS and the taxpayer at the appeals level.

But, certainly, from GAO reports and from what I have heard from our members who are tax professionals is that at the auditing level there is often a lack of knowledge about the proper amount due. There are positions taken. It is almost like a negotiation strategy rather than trying to figure out what is actually——

Mr. PORTMAN. Starting out high and ending up lower?

Mr. KEATING. Right, exactly. Now, I hope in the training for the TCMP that the auditors will not be dealing with these types of audits in the same way. They have to take a view that if the IRS is going to have accurate data, the TCMP audit is not something that is a negotiating technique with the taxpayer to find the highest amount that they think they can squeeze out of the taxpayer, but something that is the actual correct amount due.

Mr. PORTMAN. The inference I draw from what you said earlier about the 97 percent is that a great many of those cases are re-

solved in a sense, in the taxpayer's favor and that the auditor's adjustment is not the final figure. In fact, it is a figure that is a compromise between where the taxpayer might have been and where the auditor was. Is that what you are saying?

Mr. KEATING. Yes.

Mr. PORTMAN. In other words, the fact that 97 percent of them are worked out I suppose would indicate that folks understand the litigation costs, as you said, or they can understand the cost benefit analysis and they are willing to work on resolving it by going to another level than where the audit had been?

Mr. KEATING. Well, certainly that is a factor but also I have heard a number of reports from our members that it is simply that there is a better level of understanding at the appeals process and more willingness to consider things that you do not see considered at the auditing level.

Mr. LANE. Could I add something here?

Mr. PORTMAN. Sure, please.

Mr. LANE. I do a fair amount of appeals work myself. I do not know how valid that number is.

Mr. PORTMAN. The 97-percent number or the——

Mr. Lane. Oh, I believe 97 percent settle, but I do not think it is all settled at less than the tax auditor or the revenue agent proposed. There are a number of ways that cases get to appeals. The important difference with appeals as opposed to a tax auditor in the office or a revenue agent in the field is that the Service has

given the appeals office settlement authority in cases.

The people on the street do not have settlement authority. Their job is to make the substantially correct tax liability based on their understanding of the law. They are not allowed to consider the hazards of litigation and for good reason. You would not want to have 25,000 employees across the United States all having their own view of what is the hazard of litigation. It is a lot easier to control 1,900 appeals officers.

Because settlement authority is not provided to those employees and it is provided to the appeals office, they have more flexibility

in resolving cases.

An awful lot of stuff that goes to appeals gets there by default. For example, the taxpayer may have moved and did not get the audit notice and the next thing they know they get a statutory notice of deficiency, or they have a deficiency assessment and they go in and say, well, I really have got proof of my home mortgage interest and my charitable contributions, so appeals opens that case up and resolves it.

Other appeals cases may be Tax Court cases never really intended to go to Tax Court. They are filed to preserve the taxpayer's ability to appeal the audit process. So a lot of "junk," that is, substantiation and documentation cases, get into appeals for resolution

which should have been closed further down in the process.

Clearly, the better people in IRS, in terms of their technical knowledge, are in the appeals function. For one thing the grades are higher, the work is better. You do not have an inventory to carry that is the size of the field inventories, and it is a nicer environment to work in. So the better people that have settlement in mind tend to gravitate toward that work.

Mr. PORTMAN. The question, I guess, for us today is what does all this mean for TCMP? Will it be any different? I do not understand what the differences might be. I think you are still going to have a number of these kinds of cases. Although I suppose change of address would not be as big a problem because someone will have sat down face to face with an auditor.

Mr. LANE. Yes. I do not know that anybody keeps separate data on what percentage of TCMPs settle out in appeals. I would imagine that it is going to be fairly consistent with regular audits.

Mr. PORTMAN. Ms. Smith, a couple of quick questions for you since you have been through the process, I understand. I am sorry I missed hearing your testimony firsthand, but you said that you had pretty good records when you went through this process and you were able to provide the information perhaps better than some

of us who are not as good at recordkeeping.

If you had come upon a situation where you did know factually that you had properly done something and yet, you did not have the marriage license or you did not have the title to the riding lawnmower or whatever it was. You had the choice of fighting it, meaning going out and hiring a professional advisor, probably an accountant, or just going along with it. What would have gone through your mind?

I mean what I am trying to get at is the problem I think which would occur in many cases where someone would say, do I go out and hire an accountant for \$500 or \$1,000 to try to resolve this

thing, or do I just pay the \$700 or \$800?

Ms. SMITH. I went through much that same process a few months ago when I got a speeding ticket and I had to decide how much I wanted to spend. Whether I wanted to just pay the fine, it was not a big speeding ticket, or hire a lawyer and go to court

and try to get the record erased or reduced in some way.

I think I would use the same standards for this. It would depend upon the circumstances and I think it would come down to a dollar amount, in large part. I am a stubborn person and if I knew I was right and if I thought I had some way of showing I was right, I would probably go forward more than a lot of people would choose to do.

If there were very much money involved, I would feel the need to go forward. If it were a minor point, like the argument I am having with an insurance company now for \$58, the stress is not worth

it. I am going to give up after about 1 hour.

Mr. PORTMAN. You might throw in the towel. Well, that is something that is an interesting part of the whole calculation of what the cost is and the burden is on the taxpayer. I appreciate your tes-

timony.

I have one final question for Mr. Lane. This just goes to a projection of what the total cost to the taxpayer would be, by that, I mean the Federal Government. I had heard some figures earlier, and I think I had mentioned in my questioning that it seemed like it was \$300 to \$500 million. You have talked about \$2.1 billion which includes kind of the lost opportunity costs, plus the actual costs. Is that something that there is a consensus on among your colleagues and those who understand the system pretty well?

Mr. LANE. I took that from the testimony, the printed transcripts of Mr. Brand's testimony today.

Mr. PORTMAN. Just adding it up?

Mr. LANE. He said it is \$559 million direct costs and \$1.5 lost opportunity costs. That adds up to about \$2.1 billion. There are some interesting things in the testimony this morning, and that

was one of them that just caught my eye.

Mr. Portman. It is a big number when you compare that to other things we are trying to do with tax modernization or any of the other programs we have ongoing to try to make the system work better and more efficiently. That is a substantial part of what we have available to try to make ours work better. So that is interesting.

Mr. LANE. I guess I look at that and look at the success they have gotten from the market segment program and think boy, the \$2.1 billion could be better spent on other things in the market seg-

ment area in terms of taxpayer compliance.

I think the key thing with any of these things we try to do in tax administration—and having spent 10 years in the Service in the beginning of my career and now 15 years in private practice—I feel qualified to comment that I think the key thing the Service needs to focus on is the impact. In an ideal environment they would only be working cases that deserve to be audited, enforcing against people who deserve to be seized, and the taxpayers who

complied basically would be left alone.

That would be an ideal environment. The taxpayer who never needed to be audited, never got audited. There are imperfections in the system—as Fred Goldberg talked about; for example, the circularity issue. Just to keep doing it because we have always done it that way, when we have got new tools available is wrong. I mean what have we spent on technology in the last 5 years in IRS? We should be able to come up with a better way of constructing a method of sorting tax returns than to go back to a model of something we used in 1963.

I am also concerned about some of the assumptions that IRS draws from the data. For example, in Mr. Brand's testimony today, there is an assumption about what impact they had in compliance

as a result of the child care issue.

You have a chance to review that. Our take on that is 180 degrees the other way. I do not believe, as he points out in his testimony, that they identified a problem with people overstating the credit and so they required the tax ID number of the child care provider. As a result, 2.7 million taxpayers stopped claiming the credit which gave them an additional \$1.2 billion in revenues, and credits that to the TCMP process.

I do tax returns, folks. There is no way that 2.7 million people were claiming a fraudulent credit and stopped taking it because now they had to put the tax ID number of the child care provider down. That is not what happened here. Rather, what happened is because they had to put the tax ID number of the child care provider down, they had to make a decision: "Was it worth turning

grandma in for the \$480 credit?"

The 2.7 million people made the decision that for \$40 a month, it was not worth disrupting their baby sitting situation. That is

what happened. I do not draw the same conclusion IRS does—I draw a conclusion that says the credit is too low. If the credit were \$2,500, they all would have thrown grandma from the train. [Laughter.]

But for \$40 a month, it is not worth it.

Mr. PORTMAN. Are they not throwing themselves from the train, too? Because it raises the whole issue of the Social Security tax.

Mr. Lane. Well, no, they may not even have grandma doing the baby sitting in the house. They may be taking them to a next door neighbor. But for \$40 a month, if you talk to most working couples, the biggest problem they have is this child care hassle and the last thing they are going to do is disrupt one that is working for a \$40 a month tax credit to play "rat fink" on the baby sitter. So the bottom line is that the credit was too low and a lot of people looked at that and said, no, I am not going to do that. I had people say, "I am not going to give you that number, just take the credit off the return."

So to turn around and draw the conclusion afterward that oh, our great TCMP provided this dramatic \$1.2 billion additional revenue because we got all of these tax cheaters off the rolls, is absolute nonsense.

I am not accusing them of being disingenuous with the subcommittee. I am just saying, this is an example of the myopia the organization has. They take these backward looks at situations and

say, oh, well, our TCMP suggested this is a problem.

The primary reason they wanted this tax law change for the TIN was that they only had 260,000 people in the country file tax returns indicating they derived income from child care. There are probably 260,000 in the city of Washington that are making child care income. So they knew they had a problem and they knew that they would get better compliance if you asked for the tax ID number. I do not think that it had anything to do with TCMP.

Mr. PORTMAN. Well, that just goes to the difficulty of making some of these estimates, not just looking back but looking forward, which is even more problematic as Mr. Keating has said, 3 years from now when we have the data available we may well have an

entirely different tax system to be working with.

Thank you, Mr. Chairman, I appreciate the testimony.

Mr. HANCOCK. Thank you.

Well, thank you, very much, to the panel. We most likely have another vote on so we will recess temporarily and the next panel will be seated and we will be back in about 15 minutes.

[Recess.]

Mr. HANCOCK. I want to welcome the next panel. I am not going to make formal introductions. Your written testimony will be made a part of the record. I would appreciate it if you would try to be as concise as possible and maybe we can wind this up by about 3 p.m., and maybe before we get another vote over there.

Would you please proceed, Dr. Scheuren.

STATEMENT OF FREDERICK (FRITZ) SCHEUREN, PH.D., VISITING PROFESSOR OF STATISTICS, GEORGE WASHINGTON UNIVERSITY, WASHINGTON, D.C.; AND FORMER DIRECTOR, STATISTICS OF INCOME DIVISION, NTERNAL REVENUE SERVICE

Mr. Scheuren. I am a former IRS employee, but I have been out of the Service now for a few months and I am teaching at George Washington University. I am not going to cover my testimony in any depth, except I would like to talk about possible alternatives to the specific 1994 proposal that you heard about this morning.

I feel that there are a number of issues around that proposal, organizational issues around the way the Service is planning to do

it—considering the way it has done it traditionally.

There are also some operational concerns with such a large endeavor, and I have recommended in the testimony that the Service conduct a "dress rehearsal" this year, instead of a full-scale study. This is a very large undertaking and dress rehearsals are typical in large statistical efforts. The Census Bureau, for example, typically conducts one or more dress rehearsals before each census. We are talking about something that is on that order of magnitude. This is a very large undertaking, and I think it deserves a dress rehearsal, especially given the things I heard this morning about the computer system.

I also want to comment about the sample design, since that is my business. In general, the work done on the sample design was extremely good, although it is constrained by some assumptions that were made. I think that there are some issues around the data available to do the sampling with—given the antiquated nature of

the IRS processing system.

I would recommend a change in the way that the sampling is going to be carried out for 1994, if a pilot or a dress rehearsal were taken. My approach would be quite simple. Just take the existing sample that has been drawn, which as I say is quite good, given the constraints, and subsample it to deal with some of the burden issues and with some of the targeting issues and with the point that we really need a dress rehearsal. Then field a sample of, perhaps, 15,000.

Now, admittedly 15,000 is a number that I pulled out of the air; but it is a significantly smaller number, an order of magnitude smaller than 150,000. You cannot settle these questions, at least in my business, without doing some empirical work. I am not sitting here saying I have done this empirical work. It requires a lot of study. But I think a small, but not too small, version of what is

planned is what is appropriate.

I think there are some issues about sample estimation and Fred Goldberg made some of these points this morning in a general way and I will make them again. I think things have moved, in my profession, in the last 30 years a great deal, and I think there are ways that we can more efficiently make estimates from a sample. That efficiency could lead to a smaller sample.

I do not want to overpromise here. I know a great many of these new methods are worth trying and some of them have actually worked. A TCMP study that I was slightly involved in (form

990-T) was one in which an efficient estimation procedure really

made some big payoffs.

I am concerned about the study analysis issues. But I think I will pass over that right now. A lot of people have talked about those issues already and others that are sitting here with me may as well.

So what am I proposing? For the immediate short run, first, one thing that I have not said here but that is in my testimony—I think the TCMP is irreplaceable and there must be a TCMP. I am not saying anything to disagree with that.

On the other hand, I think a smaller, targeted, better planned, more carefully developed TCMP, in terms of the dress rehearsal

idea, is essential for the fall.

What would I recommend that we do afterward? Again, I have seen it in the testimony of others today. I would recommend that TCMP become an annual study, that it be smaller annually. Certainly a lot smaller annually than it is for 1994. It could become more efficient over time. One of the things that we need to learn from the Japanese is "just-in-time" procedures and short cycle times. If we do TCMP the right way, we can learn how to do it better and better; reduce the burden on the taxpayer by making TCMP smaller and smaller; and the burden on the resources of IRS would be a lot less as well.

That's my recommendation. Since many of you here are in the political world, you understand the nature of rolling samples, of tracking polls. This is the way to do business—quite different than doing a measurement every few years. I think this approach should be taken in TCMP. Furthermore, I think it is consistent with the Service's desire to modernize itself.

Thank you.

[The prepared statement follows:]

Testimony

To

Committee on Ways and Means U.S. House of Representatives Subcommittee on Oversight

By Frederick (Fritz) J. Scheuren Visiting Professor of Statistics The George Washington University

Tuesday, July 18, 1995

My statement today on the Taxpayer Compliance Measurement Program (TCMP) will cover --

- How TCMP data differ from data produced in the Statistics of Income (SOI) program.
- The value and use of TCMP data, and
- The benefits and shortcomings of the current TCMP design.

In addition, I would like to discuss some alternatives to the current approach that the IRS is intending to take.

Disclaimer and General Perspective

First, a disclaimer may be in order. I am here solely as a private citizen. However, at present I am a part-time consultant to the Treasury Task Force on Tax Refund Fraud; also, I have travelled to Russia for the Treasury Department to consult on tax matters. Indeed, I'll be going to Moscow again next week; this is partly under Treasury auspices and partly for The George Washington University, where I am employed full-time as a visiting professor of statistics.

Second, my overall perspective may be worth noting. Over the years my involvement with TCMP has been both professional and personal. In fact, I worked as an apprentice statistician to help draw the first TCMP samples back in the 1960's -- just after I came to Washington to "serve my country" as an IRS employee. My recent knowledge of TCMP is nothing like as detailed now as it was then. I will, therefore, speak quite generally, posing questions more than offering answers. Much of what I have to say is very supportive of what TCMP is all about. On the other hand, I have some questions on the approach being taken. In my view, there are places where a wiser course may be open to the IRS.

TCMP and SOI Data

Let me begin now with a discussion contrasting TCMP and SOI data -- the kind of data each program collects, with what frequency and focus:

- Large-scale, usually annual studies are mounted of tax returns and information
 documents as part of the Statistics of Income (SOI) program. This is the program,
 incidentally, which I led for many years when I was at the IRS. These SOI data are
 taken from the <u>unaudited</u> reports of taxpayers and third party filers.
- Taxpayer Compliance Measurement Program (TCMP) data, in contrast, have historically been periodic in nature, rather than annual. Furthermore, the data collected have been <u>audited</u>.

In no real sense are TCMP and SOI data substitutes for one another. Both are needed. For some 80 years, SOI data have been made available to study who pays the taxes, to benchmark measures of the National economy (like GDP), and to study the effect on reported taxpayer behavior of changes in tax laws. TCMP data, available periodically over the last 30 years, obviously have always had a compliance focus.

The main uses of TCMP in connection with SOI have been to provide correction factors for the underreporting of SOI income amounts and the overreporting of SOI deductions. What has not happened is to develop a unified design embracing both of these important IRS statistical programs. The usually much larger (and considerably less expensive) SOI samples could improve TCMP estimates — perhaps greatly. I will return to this point later.

Value and Uses of TCMP Data

There are many others whom you will or have heard from on the value and uses of

TCMP data; therefore, I will be brief.

Unquestionably, TCMP data have considerable value -- notably for policy makers and for the economists who maintain the U.S. National Income and Product Accounts. Uses, of course, by the IRS over the years have been many, including such statistical measures as the tax gap; even so, the operational application of TCMP data can be frustrating. Among the reasons I have heard for this are --

- TCMP's (perceived) lateness and the fact that, in the meantime,
- Legislative or other changes may have intervened -- making it hard to know how to
 employ the results.

Documentation issues may exist too, as I have learned personally, if one wishes to make comparisons over prior TCMP studies on topics not looked at earlier.

A strength of TCMP is that it is comprehensive in scope. This makes it possible to rank by importance the compliance issues IRS faces — even to use the rankings to help the agency set priorities for employing its scarce resources. On the flip side, sample sizes for some compliance areas of concern may be insufficient to provide enough detail to inform action. Even when the samples are large enough, they may not be frequent enough to decide whether legislative or administrative changes had the desired effect. The alternatives implicitly here are either more frequent TCMP studies or a series of single issue studies. Both probably are needed — I will return to this point later.

Benefits and Shortcomings of Current Design

The complexity of mounting such a large statistical effort as TCMP within an operating environment is daunting. That it has been done and done well over the years is a real achievement. Nothing I have to say below should be interpreted as contradicting this; nonetheless, many improvements may be possible. I will mention a few here.

Organizational Issues. -- Historically, each TCMP has had an ad hoc structure, with many new individuals involved in a temporary endeavor. Though carefully trained, each study's workers have mainly been first-timers. It is, moreover, a commonplace within the IRS that TCMP is seen as interfering with the real work of the agency. Issues of organizational learning, therefore, exist in this environment; the process of trying to make continuous improvements may have slowed (even suffered) as a consequence.

Operational Concerns -- The upcoming TCMP is particularly vulnerable to concerns about the likely quality of the work to be done, given the long time between studies. Typically, in statistical projects of this size a full scale "dress rehearsal" would be carried out before fielding such an ambitious effort. I have not seen all the extra management controls IRS will put in place to carry out its ambitious goals. Maybe if I had, I would not feel the way I do; but at this point I strongly recommend the IRS not go forward as planned with a full study. A sizable pilot makes sense instead (perhaps on the order of 10% or so of the current planned effort).

Sample Design.— Some time ago, I saw the TCMP sample design and talked to the statisticians who developed it. Incidentally, I was still an IRS employee at that point; my "need to know" involved work I was then doing to manage the statistical aspects of the 1993 EITC Studies (which you have heard about at various points over the last year). While I questioned then, and still question, some of the 1994 TCMP planning assumptions, my impressions of the sample design work done are that it is of an exceedingly high calibre. My recommendation above that a pilot be conducted would allow time to test some of these design assumptions. The idea of market segment stratification, for example, is an inspired one but not fully tested—more a hunch than a scientific conclusion.

Sample Selection. -- Because of the antiquated nature of IRS computer processing, the TCMP sample, as well done as it is, still may not be adequately targeted. A two-stage design might be a better approach:

- The current TCMP sample would continue to be selected as now. Once drawn, case files would be built (adding information documents, etc.) -- again as is now underway.
- From this initial large sample a subsample would be selected, presumably better targeted because more information could be employed in its selection. (This subsample might be the pilot sample mentioned earlier.)

Sample Estimation -- Issues have been raised about the size of the TCMP sample. Does it need to be so large? My answer to this is I do not know, but I suspect that more looking at modern ways to make survey estimates could pay off in (at least somewhat) reduced sample

sizes. Work which I initiated some years ago on a TCMP sample of Form 990-T filers showed some of this promise from improved estimation methods. This too would be something to study, if a pilot were conducted.

Study Analysis. — At one point the upcoming 1994 TCMP was supposed to be the last traditional TCMP. New measures based on operational data were to replace the program. Frankly I have not followed this particular possibility, since it was discussed some years ago. If this is still seriously being considered, it raises many concerns. What is needed is not a TCMP effort divorced from these operational measures but a blend of the two over several years. Under such a proposed scenario, it is conceivable that TCMP could be reduced in scope as the newer methods are seen to be working. It is unlikely, though, that TCMP should end altogether, even then.

Summary and Possible Alternatives

Let me summarize my comments about TCMP briefly and then look at some possible alternatives. So far I have made two main points:

- First, TCMP is an irreplaceable technique for understanding a whole host of economic and tax compliance issues.
- Second, I have raised a number of specific questions about the 1994 TCMP that
 may be worth further study. My main point throughout is that the current 1994
 plans be scaled down to be simply a "dress rehearsal."

Implicit in my discussion has been the idea that everything be done to reduce the burden on individual taxpayers of TCMP. This should be a major consideration in framing alternatives.

What about possible alternatives, then? A key question not addressed by me is what should happen after the 1994 "rehearsal" that I have recommended Basically, I would suggest --

- TCMP become a continuous program,
- Much smaller annually than the 1994 sample,
- Carried out by a permanent cadre of employees,
- With an adaptive statistical design that could be responsive to new conditions and to what was being learned from previous studies.

To give TCMP some completely new thinking, the IRS should seek help from the National Academy of Sciences — a practice it has followed with some success in the past. One issue for the National Academy to look at would be how to integrate the SOI and TCMP designs so each can be strengthened; also the Academy might be asked to consider how to integrate special compliance studies into a general framework, like that provided by TCMP.

Concluding Comments

Allow me two last comments and then I will be happy to answer any questions that the Committee may have:

- First, I have tried to express some very technical ideas in non-technical language.
 My apologies for what I fear are the many points at which I may have failed.
- Second, I hesitate to use this analogy but it may fit. Alvin and Heidi Toffler have been talking about building third wave systems to replace second wave ones. My criticisms of the current TCMP plans are consistent with the Tofflers' ideas. What I am recommending is a third wave approach to TCMP. At present, the IRS has taken largely a second wave one.

I am done now. My thanks to the Subcommittee for inviting me to participate. Also, I wish my former colleagues at the IRS the very best in their work on TCMP. However much we may differ on approach, the work IRS is trying to do is important and valuable; I have no doubt it will be carried out with professionalism throughout.

Mr. HANCOCK. Thank you, and now we will hear from Ms. Long.

STATEMENT OF SUSAN B. LONG, PH.D., DIRECTOR, CENTER FOR TAX STUDIES, SYRACUSE UNIVERSITY, SYRACUSE, N.Y.

Ms. Long. I will summarize my statement that I have submitted. I basically have three points. No. 1, that I think TCMP is tremendously important and should be continued.

No. 2, that I think we could get a lot more mileage out of TCMP if we had broader public access to the data, and hence, more people

looking at it.

No. 3, I have some specific suggestions as to how we might use

TCMP creatively to reduce overall taxpayer burdens.

My acquaintance with TCMP goes back a lot longer than I would like to remember. When I was a graduate student 25 years ago, I first sought access to TCMP data from the IRS for my research on taxpayer compliance and IRS operations. At that time, no TCMP information was made available publicly by the IRS and indeed, the GAO complained because it could not get aggregate statistics from TCMP.

Because IRS did not voluntarily release it, my husband and I ultimately filed suit in 1975 under the Freedom of Information Act and we were, after very lengthy litigation, ultimately successful and forced the release of over 1 million pages of TCMP statistics

reports as well as some microdata files.

My first point is that I really think that after all of this time, while I have often been viewed as a critic of IRS, I think TCMP is a tremendously important program and should be continued. I go into this, in some depth, in my written testimony and many of those points were already covered and I will not emphasize them here. But basically the bottom line is we really do not have a substitute yet for the idea of random selection. TCMP may be able to be improved but the basic concept of TCMP remains and should be continued.

I also want to point up something that was not in my written testimony but came up in earlier questions in other panels as to the underground economy. The TCMP that these hearings are focusing on concerns individual and corporate returns that are filed. But TCMP has also been used to go after the nonfiler program. The last survey on that topic was in 1988. So it is possible for this mechanism of random selection to be used to examine the problem of nonfilers.

Now, the second point that I want to make is how we might get more out of TCMP. While I view TCMP as an essential tool for good government, one question must be examined, Have we gotten the most mileage from it? I do not think we have. It would be surprising if there was not room for improvement in any government

program.

One very simple, but obvious point, is that for the information to have value it must be distributed and used. Because IRS, for far too long, sought to restrict access to this data, society has not reaped the benefits from TCMP that are possible. Even within the agency, itself, the insights provided by TCMP data have not been sufficiently exploited.

In these tight budgetary times, I believe that one way that more could be gotten out of TCMP is by making TCMP microdata files available for analysis outside the agency. This would in no way im-

pinge on individual taxpayer privacy.

For many years IRS has sanitized microdata files from its statistics of income programs and made them publicly available. Although IRS has argued that access to TCMP microdata would somehow impair its collections strategies, these fears are largely misplaced.

There is no reason not to release historical files. For more current data there are numerous approaches that could be adopted to

meet IRS concerns while still allowing broad access.

The third and final point I wanted to turn to is the issue of taxpayer burdens. It has been suggested in some quarters that TCMP is a burden for the taxpayers that are selected for this special audit. Of course, this is true. In a similar way serving on a jury is a burden, sometimes a big one, but being judged by a jury of one's peers improves the chances of a fair system for all. So it is with TCMP, the existence of which can lead to a more equitable and efficient tax system for all.

Historically TCMP has been used mostly for identifying ways to modify the behavior of taxpayers. An equally important but underutilized purpose should be to identify ways that the tax system can be modified to help taxpayers meet their obligations with

the minimum administrative hassle.

Let us face it, a great deal of burden is imposed by our tax system on all taxpayers. We should think creatively as to how we could use information to eliminate some of these unnecessary hassles.

Two of these areas that occur to me are in the area of complexity of tax laws. First, we could use TCMP to assess just how much complexity leads to noncompliance. My written testimony goes into that, and hopefully would allow Congress to better confront that

problem with real figures.

Second, we could use TCMP to provide us a window on IRS audits and, therefore, to pinpoint areas where IRS auditors are raising inconsistent or unnecessary claims. I have a number of suggestions as to how that might be achieved and, thereby, get the maximum leverage out of TCMP and in the long run reduce taxpayer burdens.

Thank you.

[The prepared statement follows:]

STATEMENT OF SUSAN B. LONG DIRECTOR, CENTER FOR TAX STUDIES SYRACUSE UNIVERSITY, SYRACUSE, N.Y.

Madam Chair and members of the subcommittee, thank you for requesting my testimony. The fair and efficient operation of our federal tax laws is a matter of central concern to every American. I very much appreciate the opportunity to present my views on what I consider a vital component in this system: the Internal Revenue Service's Taxpayer Compliance Measurement Program (TCMP). My testimony is divided into three areas: (1) the fundamental importance of TCMP in efforts to improve the fairness and efficiency of the federal tax system, (2) the need for improved access to TCMP data in reaching these goals, and (3) specific suggestions for how TCMP could be used to help reduce unnecessary taxpayer burdens.

My acquaintance with TCMP goes back longer than I like to remember. Twenty-five years ago, when I was a graduate student at the University of Washington, I first sought access to TCMP data from the Internal Revenue Service for my research on taxpayer compliance and IRS operations. At that time, no TCMP information was publicly released by the IRS. Indeed, the General Accounting Office complained that it could not obtain access to even aggregate TCMP statistics. Because IRS did not voluntarily release TCMP data when I requested it, my husband and I ultimately filed suit in 1975 against the IRS under the Freedom of Information Act. This suit eventually was successful in forcing the public release of over a million pages of TCMP statistics, agency internal reports and analyses, details on the sample designs, and computer tapes containing the underlying checksheets (after deleting taxpayer identities) made out by IRS auditors on many of the returns covered by TCMP studies.

While I have long been viewed as a critic of the IRS, after years of research I remain convinced that TCMP is one of the most important government initiatives aimed at making our tax system work in a more efficient, fair and less intrusive manner.

WHY IS TCMP SO IMPORTANT

The Taxpayer Compliance Measurement Program is essential because without it the IRS, Congress, and the public would be flying blind about the operation of the government's central function -- tax collection.

"The revenue of the state is the state," wrote Edmund Burke, the eighteenth-century statesman and historian. Put another way, without the legal authority to collect taxes and the compliance of citizenry to these laws, government is a sham. It is this fact—that taxes are profoundly essential to the existence of all successful states—that makes information about the functioning of our tax system essential. Without reliable and valid information, tax collectors actions may be misguided and ineffective, citizens may be unduly burdened or unfairly treated, and the citizens' elected representatives will be hampered in their attempts to correct these failings. Without the continued and systematic monitoring of how our tax system is working, we will not recognize problems until they have become festering social and economic problems. Without solid grounding in the facts, actions designed to improve our tax system and its administration are less likely to produce their intended results.

How can we obtain reliable and valid information about the true functioning of our tax system? Congress has long recognized the need for such information. Encountering difficulties in getting the information it desired out of the Treasury Department after federal income tax laws were instituted following approval of the Sixteenth Amendment to the Constitution in 1913, Congress mandated that government prepare and publish annual statistics about the operations of the federal income tax laws. The Statistics of Income (SOI) program was born in response to this

mandate, and the "Tax Model" files and related SOI reports which continue to this day are relied upon by IRS, the Treasury Department, Congress, scholars, and the public at large.

The SOI data, however, reflect the information that is reported on tax returns. Not all taxpayers file required returns, and the information reported on returns that are filed is often incorrect. This is where TCMP comes in. It examines the tax compliance behavior of 120 million business and nonbusiness taxpayers by looking at the behavior of a relatively small scientifically valid "random sample." This program and its predecessors dates back to at least the 1940s -- almost fifty years.

There are countless examples of how TCMP has provided indispensable information that could not be obtained in any other way. Specific legislative and administrative improvements taken as a result of TCMP findings are well-known and have saved taxpayers many, many times the cost of the program.²

The plain fact is that there are no known substitutes for this approach that will produce comparable information. In the late 70s, for example, the Justice Department commissioned a comprehensive study on measuring white collar crime. This study, which I worked on, singled out IRS's TCMP program as the model which offered the only generic approach for measuring most regulatory and white collar offenses. I am unaware of any magic breakthrough that changes this assessment today which would offer a substitute for the TCMP approach.

GETTING THE MOST OUT OF TCMP

While I view TCMP as an essential tool for good government, one question must be examined: Have we gotten the most mileage from it? In my opinion, the answer is no. It would be a surprising government program, of course, where there was no room for improvement. One very simple but obvious point is that for information to have value it has to be distributed and used. Because IRS for far too long sought to restrict access to these data, society has not reaped the benefits from TCMP that are possible. Even within the agency itself, the insights provided by TCMP data have not been sufficiently exploited.

I believe TCMP data are as essential to the nation as Commerce and Labor Department information on the economy and even Census data on the population. This is because TCMP provides powerful facts and insights that could lead to improvements in the tax law and its administration. The potential impact here is hard

¹ The Bureau of Internal Revenue (as the IRS was then called) launched the Audit Control Program right after World War II using audits of random samples of taxpayers to measure taxpayer compliance. TCMP as we know it was formally launched in 1962.

For examples of TCMP uses see Internal Revenue Service, Taxpayer Compliance Measurement Program: Sample Design Documentation, Document 9293 (Volume I (1993) and Volume II (1994); Internal Revenue Service, Taxpayer Compliance Measurement Program Handbook, Document 6457 (Revised Edition, 1989); General Accounting Office, Taxpayer Compliance: Status of the Tax Year 1994 Compliance Measurement Program, GAO/GGD-95-39 (December 1994); George Guttman, "Taxpayer Compliance Measurement Program: Is It Necessary?" Tax Notes, June 5, 1995, pp. 1282-1288.

³ Susan B. Long, <u>The Internal Revenue Service: Measuring Tax Offenses and Enforcement Response</u>. Washington, D.C.: U.S. Government Printing Office (1980).

to exaggerate. Because taxes are a vital component in our economy, improvements necessarily will have wide ramifications for everyone's pocketbook. Beyond the immediate functioning of the economy, the way taxes are collected strongly influence public attitudes towards government and our laws.

Since my FOIA litigation, IRS has taken some steps to make TCMP more accessible to the public. They now routinely release tabulations and analyses they prepare from TCMP. For a time the IRS had a program which allowed researchers, with IRS assistance, to undertake their own studies. The agency also sponsored annual conferences where IRS staff, tax professionals and academics shared research findings. This cross-fertilization reduced the insularity that had long plagued IRS. In recent years, however, agency TCMP analyses have sharply declined and collaborative research has diminished.

In these tight budgetary times I believe that one way that TCMP research can be increased is by making TCMP micro-data files available for analysis outside the agency. This would no way impinge on individual taxpayer privacy. For many years, IRS has sanitized micro-data files from its Statistics of Income program and made them publicly available. Although IRS has argued that access to TCMP micro-data would somehow impair its collection strategies, these fears are largely misplaced. There is no reason not to release historical files. For more current data, there are numerous approaches that could be adopted to meet IRS concerns while still allowing broad access.

REDUCING TAXPAYER BURDENS

It has been suggested in some quarters that TCMP is a burden for the taxpayers who are selected for this special audit. Of course this is true. In a similar way, serving on a jury is a burden -- sometimes a big one. But being judged by a jury of one's peers improves the chances of a fairer system for all. So it is with TCMP, the existence of which can lead to a more equitable and efficient tax system for all.

Historically, TCMP has been mostly used for identifying ways to modify the behavior of taxpayers. An equally important, but under-utilized purpose, should be to identify ways the tax system can be modified to help taxpayers meet their obligations with the minimum administrative hassle. I am not limiting this to only changing IRS procedures. It is also essential that TCMP be used to identify problems in the way Congress has written the tax laws that impose unwarranted complexity or regulatory burdens. Two examples of what I am talking about come to mind.

Everyone bemoans the many burdens imposed by the complexity of tax requirements. But partly because the costs of these burdens have not been quantified and the specific problem areas identified, we have failed to confront this very grave problem. This did not have to be the case. Past TCMP data, if properly analyzed, could have provided detailed information about components of noncompliance arising from unnecessarily complex tax provisions. 4

⁴ The Center for Tax Studies at Syracuse University has pioneered additional ways of measuring components of tax complexity keyed to line items on tax returns filed by individuals. Research studies show that tax complexity appears to be a major cause of the differences between taxpayer reports and IRS TCMP auditor findings. See Susan B. Long and Judyth A. Swingen, "The Impact of the Tax Reform Act of 1986 on Compliance Burdens: National Survey Results," in The Impact of the Tax Reform Act of 1986: Did It Improve Fairness and Simplicity? Internal Revenue Service Publication 7302 (1989); Susan B. Long and Judyth A. Swingen, "The

In response in part to suggestions from Congress and the academic community, the current TCMP survey has added specific questions designed to help identify trouble-spots where complexity is the primary source of audit adjustments, along with very detailed issue coding to pinpoint specific sections of the tax law where this occurs. More attention needs to be focused upon pretesting this part of the survey, the selection of categories, and the proper training and instruction of the auditors. Although I thus have some reservations about aspects of TCMP's planned implementation, the potential of identifying problem laws and measuring their compliance costs could be enormous. Armed with detailed information about the true costs of complexity, Congress, tax professionals, and the IRS could mount genuine reform. With the better understanding of the actual costs of compliance, Congress could confront and debate these issues before it passes new tax legislation.

Second, TCMP could also play a vital role in identifying correctable administrative failures which make taxpayers' lives difficult. TCMP provides a unique window on IRS auditor behavior. There is a variety of evidence suggesting that there are gross inconsistencies in how individual auditors, Service Center personnel and collection officers treat taxpayers. Data analyses at my center have repeatedly shown enormous and inexplicable variation in audit and collection practices from one district to the next.⁵ Internal IRS studies, backed by GAO reports, have discovered that inappropriate advice and collection claims occur all too often. When contested, initial IRS auditor findings are frequently abandoned. A recent GAO study, for example, showed that only 22 percent of taxes recommended by IRS's audits under the Coordinated Examination Program between fiscal years 1983 and 1991 were eventually collected after any appeals or litigation.⁶ My analyses using TCMP data matched with IRS Master File records showed significant differences between TCMP noncompliance estimates and final assessments after a taxpayer appeal.⁷ Studies by other tax authorities have found striking inconsistencies in auditor judgments on the same return.⁸

Role of Legal Complexity in Shaping Taxpayer Compliance," in Van Koppen, Hessing, and Van Den Heuvel (eds.), <u>Lawvers on Psychology and Psychologists on Law</u>. Amsterdam: Swets & Seitlinger (1988), Susan B. Long and Judyth A. Swingen, "An Approach to the Measurement of Tax Law Complexity," <u>Journal of the American Taxation Association</u>, Spring 1988.

⁵ See, for example, David Burnham, <u>A Law unto Itself: Power, Politics and the IRS</u>. New York: Random House (1990, Appendix, pp. 377-395).

⁶ Tax Policy and Administration: 1994 Annual Report on GAO's Tax-Related Work, GAO/GGD-95-66 (February 1995), p. 44. See also GAO/GGD-94-70; Susan B. Long and David Burnham, "Solving The Nation's Budget Deficit With A Bigger, Tougher IRS: What Are The Realities?" Tax Notes, August 6, 1990, pp. 741-757.

⁷ Susan B. Long and Judyth A. Swingen, "Taxpayer Compliance: Setting New Agendas for Research," <u>Law and Society Review</u>, volume 25, number 3 (1991), pp. 658-660.

⁸ See, for example, Henk Elffers, <u>Income Tax Evasion: Theory and Measurement</u>. Denventer: Kluwer (1991); Henk Elffers, Henry S. J. Robben, and Dick J. Hessing, "Under-Reporting Income: Who Is the Best Judge--Taxpayer or Tax Inspector?" 154 <u>Journal of the Royal Statistical Society</u> (1991 Ser. A), Part 1, 125; Henk Elffers, Henry S. J. Robben, and Dick J. Hessing, "Reliability and Validity of Tax Audits: Can We Have Confidence in the Opinion of the Dutch IRS on Noncompliance?" Working Paper, Erasmus Centre for

These unwarranted inconsistencies impose a hidden and vast burden on millions of taxpayers each year. This burden is unnecessary. With the proper design of TCMP research and its sincere application to problems not only of taxpayers but tax administrators, a large step could be taken in reducing these destructive enforcement deficiencies.

How could this be achieved? First, TCMP surveys should not stop with the initial finding of the auditor. While these can continue to provide valuable information, TCMP noncompliance estimates should include the revisions that occur in tax assessments after taxpayer appeals.

Studies have found, however, that taxpayers frequently do not contest auditor claims they disagree with because such appeals are costly and painful. 9 This fact means that more is required to obtain a comprehensive picture of wrongful auditor claims. TCMP should be used directly to assess the consistency of auditor judgments. In pretesting the TCMP survey auditor judgments on the same hypothetical taxpayer situation should be compared to identify and correct inconsistency problems. Further, during the TCMP audits themselves, the consistency of auditor judgments should be continually monitored. This approach has been successfully used by the Dutch tax authorities. (See footnote 8 above.)

This would not only provide a truer picture of tax compliance, but help pinpoint those areas where IRS training and supervision needs to be improved so that taxpayers do not face unfounded auditor claims as often occurs during routine tax examinations. While it is impossible to estimate the proportion of taxpayers who confront wrongful government claims, there is fairly persuasive evidence that they represent a lot of people.

CONCLUSION

In conclusion, TCMP is an extraordinarily valuable resource that needs to be continued. Second, while TCMP is admittedly a burden on the few, its product is an essential tool for reducing the considerable burdens on all of the nation's taxpayers. Third, although TCMP is valuable now, it can be improved. A key to such improvement, in my view, is to provide much wider access to TCMP data so that a much larger community can contribute to the essential task of identifying and correcting the shortcomings in our tax system.

Sociolegal Research (1989).

⁹ General Accounting Office, <u>Audit of Individual Income Tax Returns by the Internal Revenue Service</u>, GGD-76-54, 1976); L. Hart Wright, <u>Needed Changes in IRS Conflict Resolution Procedures</u>, American Bar Foundation (1970); Susan B. Long, <u>Measuring Tax Offenses and Enforcement Response</u>, Washington, D.C.: U.S. Government Printing Office (1980).

Mr. HANCOCK. Thank you, Ms. Long. Mr. Feinstein.

STATEMENT OF JONATHAN S. FEINSTEIN, PH.D., PROFESSOR OF ECONOMICS, YALE SCHOOL OF MANAGEMENT, NEW HAVEN, CONN.

Mr. FEINSTEIN. Thank you, very much. I would like to also loosely follow my written comments, omitting some things that have already been discussed today and adding a few remarks that might be useful.

I am a professor of economics at the Yale School of Management and I have studied noncompliance and tax enforcement for the past 8 years, working with both TCMP data and ordinary IRS audit data and I will say a little bit about both of those. I have written a series of research papers during that time, served on committees overseeing IRS research programs, and worked with several State tax authorities.

I am going to talk a little bit about my own experience with TCMP and then comment on the usefulness of TCMP. I have worked extensively with both the 1982 and 1985 TCMPs. I have found TCMP data to be very clean with few, if any, missing values or obvious miscodings, and I say that by way of contrast with some

other government data sets I might have worked with.

I have used TCMP to study three issues. First, I have investigated the relationship between household characteristics such as marital status and self-employment, and the underpayment of taxes. Second, I have calculated detection rates for individual IRS tax examiners, demonstrating how TCMP can be used to help the IRS evaluate the performance of its examiners. Third, I have estimated the tax gap. If you extrapolate forward, my estimates would suggest that the tax gap presently is at least \$120 billion. I would consider that to be a conservative estimate. I would not be surprised if it was quite a bit more than that.

The magnitude of the tax gap, I think, illustrates the importance of IRS audit programs. I wanted to make one further comment about that. If you look at other countries, the proportion of taxes unpaid, that is the tax gap, compared to government revenues is substantially higher. One important difference between those countries and the United States is that the IRS has a TCMP, I believe.

Now, the primary reason for conducting a TCMP is to help the IRS develop audit selection guidelines. In the remainder of my testimony I would just like to address whether TCMP is essential for these audit programs or whether it could be replaced by cheaper alternatives. I would like to say a bit about if it is essential, how large should it be?

I just wanted to also begin by noting that IRS audit selection is of a very high quality. IRS audit productivity, as measured by the average audit assessment, has increased fourfold during the past 30 years controlling both for inflation and for the increase in tax burden that has occurred during this time period. That is a very high level of productivity increase.

If the IRS simply selected household returns for audit at random, it would collect far less than \$1,000 on each audit. Because it has sophisticated methods to select households for audit, it currently

collects, on average, well more than \$5,000 on each audit. Those numbers are useful in saying something about what the costs of the TCMP are in terms of the opportunity costs to examiners. Every time a TCMP audit is done, at least \$4,000 is given up because some more productive audit could have been done.

So, for example, if 50,000 households are selected for TCMP audit, that would be approximately \$200 million given up of Fed-

eral revenues to do those TCMP audits.

IRS audit programs not only generate direct audit assessments but also generate additional indirect revenues to the deterrent effect they exert on potential cheaters. Although indirect audit revenues are difficult to measure, most experts agree that they are sub-

stantially larger than direct assessments.

Now, in my view, a considerable body of evidence indicates that TCMP is critical for the design and implementation of IRS audit selection guidelines. One of the most important uses of TCMP is in the development of DIF. During the past 3 years, Brian Erard, who is at Carlton University, and I have investigated IRS audit programs in the Oregon district in considerable detail. Our analysis is based on a large data set we have assembled and includes most of IRS audits of Oregon households for tax year 1987.

What we find when we look at the data is that nearly one-half of all IRS audits are based on DIF. Further, we find that these DIF audits generate significantly larger assessments, on average, than are generated by the remaining non-DIF audits. These findings, I think, strongly suggest that DIF and, hence, TCMP is, in indeed,

a critical factor in audit selection.

I wanted to remark parenthetically, by the way, that Brian has also helped the IRS on a recent study of nonfilers, an issue that came up earlier today. I just wanted the subcommittee to know that there has been a recent study of nonfilers which you might want to take a look at, although, in fact, nonfilers are a pretty small amount of the total noncompliance tax gap that we have in the country.

TCMP is also useful in helping IRS researchers discover patterns of noncompliance that have been overlooked by existing audit programs. A good example of this is the discovery a few years ago, based on an analysis of TCMP data, of the fictitious dependents problem which has already been discussed today, so I will not talk

about it further.

What are the main alternatives to TCMP? I think probably the clearest alternative would be to rely on ordinary audit data instead of TCMP data to come up with audit selection guidelines. In fact, ordinary audit data is not an adequate substitute for TCMP data. TCMP is a random sample and provides an accurate picture of the entire taxpayer population. Ordinary audit data does not and we could talk about that further if we need to, but I have worked with both kinds of data and see some clear differences between them.

A second alternative would be survey data. Unfortunately, survey data is extremely unreliable in this area. The third alternative would be to abandon statistical analyses and instead rely on examiner expert judgments. I did want to note that currently the examiner judgments are used in combination with DIF very effectively, but I do not think that they could serve as an adequate substitute

for DIF. I think they are better in combination with something like DIF.

I do think TCMP is essential for the IRS in some form. I think a question still remains as to how big TCMP should be. I just wanted to say a bit about the household component. In the past, TCMP sampled about 50,000 households. The proposed TCMP

would sample 90,000 households.

Expanding the sample would surely allow the IRS to get greater sampling densities in certain subpopulations. It is my experience that some population subgroups are very thin in existing TCMPs down to say a few dozen taxpayers which can make it difficult to determine what kind of tax audit systems to use. I do not think I would want to reduce that very far. But I have to say that based on what I know, I am not convinced that the substantial cost involved in expanding the TCMP would be worth the benefits to be gained, which seem to me to be uncertain.

I will say I have not seen all the evidence about that, but I am

not convinced at the moment of what the benefits would be.

Thank you for the invitation to testify, and I hope my testimony is useful for you.

[The prepared statement follows:]

TESTIMONY

To Committee on Ways and Means U.S. House of Representatives Subcommittee on Oversight

By Jonathan S. Feinstein Professor of Economics Yale School of Management

Tuesday, July 18, 1995

I have studied tax noncompliance and tax enforcement for the past eight years. I will begin my testimony by briefly describing my own experience with TCMP. In the remainder of my testimony I will comment on the usefulness of TCMP for IRS audit programs, first reviewing some facts about IRS audit programs, and then discussing the way TCMP is currently used, possible alternatives to TCMP, and the proposed expansion of TCMP.

I have worked extensively with both the 1982 and 1985 TCMPs (Exhibits 1, 2, and 3). I have found TCMP data to be very clean, with few if any missing values or obvious miscodings. I have used TCMP to study three issues. First, I have investigated the relationship between household characteristics, such as marital status and self-employment, and the underpayment of taxes. Second, I have calculated detection rates for individual IRS tax examiners, demonstrating how TCMP can be used to help the IRS evaluate the performance of its examiners. Third, I have constructed estimates of the tax gap for 1982 and 1985. My estimates suggest that the tax gap is presently \$120 billion or more. The magnitude of the tax gap illustrates the importance of maintaining and improving IRS audit programs. A number of other economic researchers have also made use of TCMP, including Daniel Nagin (Carnegie-Mellon University), James Poterba (Massachusetts Institute of Technology), and Joel Slemrod (University of Michigan).

The primary reason for conducting a TCMP is to help the IRS develop audit selection guidelines. Is TCMP essential for IRS audit programs, or could it be replaced by cheaper alternatives? If TCMP is essential, how large should it be? In the remainder of my testimony I will address these questions.

Let me begin by noting that IRS audit selection is of high quality and has a significant impact on federal tax collections. IRS audit productivity, as measured by the average audit assessment, has increased fourfold during the past 30 years, controlling both for inflation and the increase in tax burden that has occurred over this time period. That is a level of productivity increase matched by few other Government programs. If the IRS simply selected household returns for audit randomly, its examiners would assess on average less than \$1,000 on each audit. Instead, the IRS relies on sophisticated methods to select households for audit, and its examiners currently assess on average approximately \$5,000 on each audit. The large difference between these numbers shows how good the IRS has become at audit selection. IRS audit programs not only generate direct audit assessments, but also generate additional indirect revenues through the deterrent effect they exert on potential cheaters. Although indirect audit revenues are difficult to measure, most experts agree that they are substantially larger than direct assessments. Currently, IRS examiners annually recommend approximately \$7 billion in direct assessments based on audits of households. Including indirect revenues, the total impact of the IRS's household audit program on federal tax collections is likely to be substantially more than \$15 billion per year.

Most observers are likely to agree that IRS audit programs play an important role in safeguarding federal tax collections. There may be less consensus, however, about the importance of TCMP for these programs. In fact, a considerable body of evidence indicates that TCMP is critical for the design and implementation of IRS audit selection guidelines. I will discuss two ways in which TCMP is useful for audit selection.

First, one of the most important uses of TCMP is in the development of DIF, a computer-based rating system that assigns a number to each return, predicting the likely yield from auditing the household that filed the return. During the past three years Brian Erard (Carleton University) and I have investigated IRS audit programs in the Oregon district (Exhibit 4). Our analysis is based on a large dataset we have assembled that includes most IRS audits of Oregon households for tax year 1987. In our data we find that nearly one-half of all IRS audits are based on DIF.

Further, we find that these DIF audits generate significantly larger assessments on average than are generated by the remaining non-DIF audits. Our findings strongly suggest that DIF, and hence TCMP, is indeed a critical factor in audit selection.

Second, TCMP is also useful in helping IRS researchers discover patterns of noncompliance that have been overlooked by existing audit programs. A good example of this is the discovery a few years ago, based on an analysis of TCMP data, that households were claiming millions of fictitious dependents. The elimination of this tax scam has saved the federal government billions of dollars.

I will now discuss what I consider to be the three main alternatives to TCMP. One alternative is to rely on ordinary IRS audit data instead of TCMP data in the development of audit selection guidelines. In fact ordinary audit data is not an adequate substitute for TCMP data. TCMP is a random sample and therefore provides an accurate picture of the entire taxpayer population. In contrast, ordinary audit data includes information only about households whose returns looked sufficiently suspicious, according to existing audit selection criteria, to trigger an audit. Households that discover a new way to evade taxes and elude existing selection criteria are not represented in ordinary audit data. As a result, the analysis of ordinary audit data cannot readily detect such new forms of evasion, whereas an analysis based on TCMP might.

The discovery of the fictitious dependents scam is a good example of the difference between TCMP and ordinary audit data and shows how important TCMP is for discovering new or previously neglected forms of evasion. The problem of fictitious dependents was never apparent in ordinary audit data, because existing audit selection criteria ignored this issue, and, because of this, few of the households selected for an ordinary audit were found to have claimed an excessive number of dependents. The problem only became apparent after a careful analysis of TCMP data, which revealed that a significant fraction of households were claiming too many dependents. Of course, once the problem of fictitious dependents was dicovered, audit selection guidelines were modified to address the problem. Let me summarize my view of the uses of ordinary audit data. Ordinary audit data is good for evaluating existing audit programs, as Brian Erard and I have done. It is not well-suited, however, to the development of new audit selection criteria, because it does not keep the IRS abreast of changing evasion patterns.

A second alternative to TCMP is survey data. Unfortunately, survey data is extremely unreliable. Typically, 70% or more of respondents on surveys claim that they pay their full tax obligation, even though the hard facts from TCMP show that in most years more than half of all households underpay their taxes to some degree.

Finally, a third alternative is to abandon statistical analyses based on TCMP and instead rely solely on examiner expert judgments in the development of audit selection guidelines. While such expert judgments are currently used effectively in combination with DIF, they are unlikely to be a good substitute for DIF. Further, even if expert systems are used more in the future than they are at present, TCMP is likely to provide a good training ground for experts, exposing them to the full range of cheating strategies.

Supposing that TCMP is essential for IRS audit programs, a question still remains as to how big TCMP should be. I will conclude my testimony by briefly addressing this issue, confining my remarks to the household component of TCMP, which I know best. Previous TCMPs sampled approximately 50,000 households, whereas the proposed TCMP would sample 90,000 households. In my experience the previous TCMPs are thin in their coverage of certain taxpayer groups and locales, so I do not think it would be wise to shrink the sample below 50,000. Enlarging the sample would allow the IRS to increase its sample size for some of these groups, which might lead to a substantial payoff in the long run. However, these benefits are uncertain and might turn out to be relatively modest. I am not familiar with all of the arguments being made in support of enlarging the TCMP. Based on what I do know, however, I am not convinced that the benefits to be earned from expanding the program are worth the substantial cost involved.

In conclusion, based on my extensive study of tax compliance and tax enforcement programs, I believe that TCMP is important and productive and should continue. I am not convinced, however, that it needs to be expanded.

I thank you for the invitation to testify. I hope my testimony is useful to you.

Mr. HANCOCK. Thank you, Dr. Feinstein. Mr. Smith.

STATEMENT OF KENT W. SMITH, PH.D., SENIOR RESEARCH FELLOW, AMERICAN BAR FOUNDATION, CHICAGO, ILL.; AND FORMER MEMBER, COMMISSIONER'S ADVISORY GROUP, INTERNAL REVENUE SERVICE

Mr. SMITH. Mr. Chairman, and members of the subcommittee, first let me note that I am speaking as an individual social scientist researcher and my comments do not necessarily reflect the views of the American Bar Foundation.

In my research on tax compliance administration since 1983, I have used the TCMP data in both tabular form and by special runs that the IRS research staff did for me. My comments are also informed by other research we have done on taxpayers' views and on research on State individual income tax audits that my colleagues and I have done in cooperation with the Oregon Department of Revenue, but at the State level this time.

Let me summarize most of my comments that are in the written testimony and highlight a few of the points. First, as others have argued, the TCMP detailed line item data for a statistically representative sample of tax returns has permitted a wide range of analyses by the Service, by many other administrative and legislative offices that have not been represented in the testimony today and by academic social scientists. As others have said, many of these analyses could not have been done with other types of data.

Two essential characteristics of the TCMP are that it, No. 1, includes a statistically sound sampling of returns that is at some level of stratification independent of the expected levels of noncompliance.

In the current form, there is an oversampling of the strata of taxpayers where there is the highest amount of noncompliance so there is a weighting toward an expectation of primarily picking up noncompliance or a heavier amount of that. It is not just simply a random sampling of the entire population of taxpayers.

No. 2, the other essential characteristic is that the audits are broad ones, examining all relevant aspects of the taxpayer's financial and tax situations. Without those characteristics, the data from the TCMP would be statistically biased and the conclusions could

very well be misleading.

Several issues are frequently raised about the design efficiency and burden of the TCMP. About timeliness. For several reasons I believe it is probably unavoidable that it will take 2½ to 3 years, at a minimum, from the end of a tax year to a time when one can have clean data and compliance estimates from an accurate high-quality, TCMP data cycle. That is built into the nature of the tax filing process and the timing of when taxpayers file and the auditing process. One has to be concerned about the taxpayers and the time and social and business obligations they have. You cannot rush an audit because that increases the burden on the taxpayers. If she had not had the time, if Ms. Smith had not had the time to get her records together, it would have been much more burdensome for her, for instance.

So a 3-year lag may be an inevitable consequence of this process. What concerns me more is the amount of time between the TCMP cycles. If there is, say, 4 years between samples of a particular type of return, then the tax policy and administrative analyses and audit selection models have a rely on data that is up to 7 years

old, given that unavoidable 3-year lag.

Before I make comments about burden, let me note that many returns selected through the sampling process end up with taxes owed, even though there was no indication ahead of time that there would be noncompliance. The TCMP audits are better at discovering unreported income than what would appear by just looking at the returns. Also many taxpayers end up with refunds that they

did not expect to be getting because they had overcomplied.

Audits undertaken, for whatever reason, are burdensome and anxious experiences which taxpayers would like to avoid. Is the burden, in principle, excessive or unreasonable? Here I think my analyses of Oregon State audits is relevant. Most of the audits I studied were general audits that were not unlike TCMP audits by the IRS. The taxpayers in Oregon considered them to be burdensome, yes, but the vast majority we interviewed did not consider them unreasonably burdensome, and by and large the taxpayers came out of the audits feeling satisfied with the process and satisfied with the outcomes. If we focus on the fairness of the procedures and the quality of the audits, many of the concerns about burden, I think, will be met.

As has been anecdotally noted, many auditors, at least in the past, resent doing TCMP audits. The normal criteria for evaluating performance and allocating work in the examinations reinforces the feeling that TCMP audits are an unreasonable burden on both

auditors and taxpayers.

In improving TCMP, attention needs to be placed on assuring that auditors are positively motivated to produce quality audits and quality data. They are the linchpin of the program and they have to be committed team members. The Service, I think, is for

the next round taking solid steps in this direction.

Some suggestions have been made by others, including a National Academy of Sciences Panel, as to how to improve the TCMP. First, I think there should be an increasing of the capability for analyzing TCMP data within the Service, probably through the DORA sites. Second, we need to develop a team of TCMP audit specialists which may overcome some of the problems of the alienation of the auditors from the process.

Third, we should seriously consider conducting annual TCMP audits with smaller samples. Doing so would allow new patterns of compliance to be identified and analyzed sooner and the data would be available on a more timely basis. You could still group the annual audit data into 3- and 4-year groups for the more detailed

kinds of analyses.

Whether or not one should do that now, this round, I am not entirely convinced because we have a lot of catchup, for instance, since 1981 for partnerships, and can we afford a small sample at

this point?

Finally, even if fundamental tax reform occurs, there will still be a need to monitor and analyze compliance with something like a TCMP involving statistical samples of taxpayers and general audits. I also think current TCMP data could be used far more than what it currently is to evaluate the compliance implications of the various reform proposals.

That concludes my statement, and I will be happy to answer any

questions.

[The prepared statement follows:]

Hearing on The Taxpayer Compliance Measurement Program

Subcommittee on Oversight Committee on Ways and Means House of Representative

Statement of Kent W. Smith American Bar Foundation July 18, 1995

Madam Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss the Internal Revenue Service's Taxpayer Compliance Measurement Program (TCMP). I am speaking as an individual social science researcher, and my comments do not necessarily reflect the views of the American Bar Foundation. In my research on tax compliance and administration, I have used TCMP data both in the tabular form made publicly available by the Service and through special computer analyses prepared for me by the staff of the IRS Research Division. My comments are also informed by research on state individual income tax audits that I and my colleagues at the American Bar Foundation and Oregon State University have done in cooperation with the Oregon Department of Revenue (DOR). Many of the audits conducted by the Oregon DOR are general audits whose coverage and thoroughness is similar to that for TCMP audits. For a sample of these audits I have read hundreds of the auditors' working papers, and we have interviewed taxpayers about their responses to the audit process. ¹

The TCMP is an invaluable tool for identifying and analyzing patterns of noncompliance and for evaluating administrative and legislative responses. While I will later outline some of the ways that I think TCMP could be improved, I begin by providing some examples of how the TCMP data have been successfully used in analyses of tax compliance. I will then detail some of the essential characteristics of the TCMP that contribute to its utility. My examples are illustrative rather than exhaustive, and others testifying today have extensively used TCMP data and can provide additional examples of the utility and limitations of the data. In his recent article on the TCMP, George Guttman has described several other successful uses of the TCMP data by the Service and other government offices.²

Some Examples of TCMP Analyses

One of the particular strengths of TCMP data is that they provide a detailed picture of patterns of compliance and noncompliance within a return. Rather than characterizing tax-payers as simply compliant or noncompliant, the detail reveals on which aspects of the tax return various types of taxpayers are more or less compliant. For instance, in our research for the American Bar Association's Commission on Taxpayer Compliance, we used TCMP data to obtain distributional information about compliance with line items. What aspects of tax reporting are particularly problematic? For a particular line item, are there many taxpayers in noncompliance by small amounts, or are there a few with large levels of noncompliance? Either a lot of little fish or a few big ones could produce the same aggregate level of dollar noncompliance, but the difference between the two patterns has large implications for resource allocation and compliance strategies. As Susan Long has also pointed out, the detailed picture of over-compliance also provides a very useful window into the level of unintentional

^{1.} Two relevant papers are Stalans, Loretta J., and Karyl A. Kinsey (1994), "Self-Presentation and Legal Socialization in Society: Available Messages about Personal Tax Audits," Law & Society Review 28: 859-95; and Smith, Kent W. (1995), "The Cultural Grounding of Tax Issues: Insights from Tax Audits," Law & Society Review 29: 201-38.

^{2.} Guttman, George (1995), "Taxpayer Compliance Measurement Program: Is it Necessary?" Tax Notes, June 5, pages 1282-88.

noncompliance. No other source can provide this key distributional information as accurately as can the TCMP.³

Steven Klepper and Daniel Nagin at Carnegie Mellon University have also used compliance patterns at the line-item level to analyze how the likelihood of detection and the severity of penalties affect compliance levels.⁴ Moreover, because the TCMP data allowed them to compare line items, they could explore the possibility of substitutions effects. Do taxpayers with opportunity for noncompliance on some aspects of their returns tend to be noncompliant in other areas, or does the opportunity for noncompliance, for instance on income reporting, "substitute" for noncompliance in other aspects, for instance the overstating of deductions? Interestingly, they found evidence for such substitutions effects, an analysis that could best be done with TCMP data. In general, there is not a high positive correlation between compliance on one part of a return and compliance on other unrelated parts. As they note, "We believe our analysis demonstrates that disaggregating noncompliance to the level of the line item on the tax return can be very revealing." ⁵

Several researchers have also used TCMP data to explore the roles various types of tax preparers and practitioners play in tax compliance patterns. Klepper and Nagin again used the detailed line-item patterns of compliance to determine that practitioners tend to increase compliance with relatively unambiguous aspects of returns where noncompliance is likely to be detected and adjusted by the IRS, while they seem to increase the likelihood of more aggressive positions in ambiguous areas with low likelihoods of detection. In our own analyses we found that the apparent relationship between practitioners and overall noncompliance is misleading. Individuals with complex financial and tax situations are both more likely to be noncompliant (either intentionally or unintentionally) and more likely to use tax practitioners. When one uses the detailed data in the TCMP to control for the complexity of the tax situation, one finds that the net effect of practitioners is to decrease overall noncompliance. In far more detailed and sophisticated analyses, Michael Udell has found similar patterns.

The Research Division of the IRS and the General Accounting Office have occasionally used the working papers from TCMP audits to obtain a fuller understanding of the problems with areas of high noncompliance. For instance, the working papers have been used to trace why exemptions for dependents were being disallowed (e.g., generally inadequate documentation and record-keeping or misinterpretation of the law) and to examine the problems with capital gains and losses (e.g., inadequate documentation for the basis, incorrect calculation of the basis, misinterpretation of the laws for carry forwards and carry backs, etc.). Such analyses can be extremely valuable in planning administrative and legislative responses to problems, but drawing the information from working papers is inefficient and labor intensive. From my work with Oregon state auditors, I know that similar information can be obtained much more efficiently through check sheets completed by the auditors for targeted issues—if the analysts and auditors cooperate in designing the check sheets and if the auditors understand and are committed to the utility of the information. This is an extension of the TCMP audits that I think should be used more often.

American Bar Association Commission on Taxpayer Compliance (1987), "Report and Recommendations on Taxpayer Compliance," Tax Lawyer 41: 329-92.

^{4.} Klepper, Steven, and Daniel Nagin (1989), "The Anatomy of Tax Evasion," Journal of Law, Economics, and Organization 5:1-24.

^{5.} Ibid, p. 23.

^{6.} For example, Graetz, Michael, Jennifer Reinganum, and Louis Wilde (1989), "Expert Opinions and Taxpayer Compliance: A Strategic Analysis." Social Science Working Paper No. 710. Pasadena: California Institute of Technology. Klepper, Steven, and Daniel Nagin (1989), "The Role of Tax Practitioners in Tax Compliance," Policy Sciences 22: 167-92. Udell, Michael A. (1991), The Effects of Tax Preparer Use on Non-Compliance with the Federal Individual Income Tax (dissertation). Pasadena: California Institute of Technology, Division of the Humanities and Social Sciences. Smith, Kent W. (1988), "Tax Practitioners and Taxpayer Compliance: A View from Intensive Tax Audits," at the Annual Conference of the Socio-Legal Group, Oxford, England, March 23.

These are just some of the many examples of the valuable analyses that can be done with TCMP's detailed data on a statistically sound sample of taxpayers—analyses that could not be done as well with other types of data. The TCMP potentially offers answers to far more questions than the IRS's Research Division can explore. But the analyses can now be distributed more widely within with Service. During the first 20 years of the TCMP, analysis involved specialized programming on a mainframe computer, and the primary emphasis was on producing a general purpose set of tables. The output literally stood several feet, and retrieval experts were needed to find the relevant information in the tables, and then the general purpose tables often did not provide direct answers to one's questions. With today's powerful micro computers and statistical programs, analyses tailored to specific questions take just a matter of minutes. They can be done by staff members with training in data analysis and the special problems of working with audit data. With the promising development of DORA sites, I hope that the Service will distribute more widely the facility for analyzing the data and thereby take much fuller of advantage of the rich TCMP data than it has been able to in the past. For this distributed analysis to be effective and efficient, however, researchers in the National Office will have to expand their functions to also be consultants on TCMP analyses, and there will need to be some mechanism for sharing analysis plans and results among DORA sites.

Two Essential Characteristics of with TCMP

The plans for the 1994 TCMP involve many improvements over previous cycles, and the program can be improved even more. However, in evaluating and modifying the TCMP, I think there are two essential characteristics that must be retained if it is to remain a useful tool for identifying and analyzing compliance patterns. These same characteristics are probably also critical for an efficient and accurate data base for developing statistical models for audit selection, such as DIF; but my focus is on the other administrative and legislative uses of TCMP.

- 1. Probability Sample of Taxpayers. To draw valid inferences about noncompliance, the TCMP data must include a statistically representative and sufficiently large sample of taxpayers who are compliant on a particular item so that their characteristics can be contrasted with those of a sample of taxpayers who are not compliant. Therefore, the program must involve a probability sampling of taxpayers that at some level of stratification is independent of the likelihood of noncompliance.
- 2. General Audits of Taxpayers' Finances. The starting point for TCMP audits must be the total financial and tax situations of the taxpayers during the tax year being audited. The TCMP auditors should not be given the latitude to focus on just those items that they think may be relevant. If they do, there will be a selection bias at the level of the line item even though it may be a statistical unbiased sample of returns.

There are several interrelated reasons why these essential characteristics should be retained

- First, adequate pictures of the incidence of noncompliance and of the factors related to noncompliance have to be based on the contrast between statistically sound samples of cases of noncompliance and of cases of compliance. One cannot determine how noncompliance differs from compliance by only or primarily looking at cases of noncompliance. Without a probability sampling and general audits, TCMP would provide a biased and misleading picture, both of the relative amount of noncompliance and, perhaps more importantly, of the factors affecting the noncompliance.
- Not all under and over compliance is reflected in the returns as filed and in third-party reports. Using only this information to select returns and issues will give an incomplete and misleading picture. To give some examples, evidence from TCMP and survey data indicates that there are appreciable numbers of individuals with small business on the side but who file 1040s without Schedule C and even 1040As or 1040EZs. Understatements of income by amounts too small to show up in expenses or living standards is widespread and, in the aggregate, a significant source of noncompliance. Individuals and businesses, for one reason or another, often do not list relevant expenses, but an accurate picture of compliance patterns should include such over compliance.

- Patterns of noncompliance are continuing changing, and basing TCMP selection and
 auditing on past auditing experience is likely to miss some of these changing patterns,
 at least in a timely manner. As someone once observed, tax compliance is like a leaky
 hose. As soon as one hole is patched, another one springs out, often in direct response. Looking where the old leaks were is not the best way to find the new ones:
 the entire hose must be inspected.
- There is also an important compliance reason for probability samples and general audits. Because opportunities for noncompliance come and go, all taxpayers should have the perception that there is some probability, however small, that their returns might be audited, even if they think they have prepared them so that they will be beyond suspicion. That audit presence for everyone is a deterrent factor, but I and others feel that it is also a important contributor to the normative support for trying to comply with tax laws. "If the government doesn't take my compliance seriously enough to be concerned about it, why should I?" Even though the TCMP sample is a minuscule percentage of returns, it helps to provide this deterrence and normative underpinning for compliance.

Concerns about TCMP Audits: Some Observations

Several issues are frequently raised about the design, efficiency, and burden of the TCMP. My comments about these issues are based on my own experience with TCMP data, discussions with IRS staff, and my analyses of Oregon state individual income tax audits.

Timeliness. For several reasons it is probably unavoidable that it will take two and a half to three years from the end of the tax year to obtain clean data and compliance estimates from an accurate, high quality TCMP cycle. Taxpayers who file late have different financial situations and taxpaying orientations than those who file early. The TCMP sampling must include both, so it cannot be completed until at least 6 months after the filing date. Once an audit begins, it often takes considerable time to obtain documents from third parties, and good auditors need to respect the many other business and personal obligations of the taxpayers being audited. Even with perfectly clean data, it still takes time to create the data base, double check for inconsistencies, and conduct the initial analyses. Thus, a 3-year lag may be an inevitable consequence of the nature of tax filing and auditing.

The data entry and checking procedures planned for the 1994 TCMP should decrease the time needed for cleaning and organizing the data, but I suspect more could be done to speed up this part of the process, especially by improving the accuracy of the initial data input by the auditors—"getting it right the first time" in the parlance of Total Quality Management. What concerns me more, however, is the amount of time between TCMP cycles. If there are three years between samples of a particular type of return, then tax policy and administrative analyses and audit selection models have to rely on data that are up to 6 years old, given the unavoidable 3-year lag.

Sample Size. Others today can address the issue of sample size more authoritatively than I can, but I doubt that the sample can be decreased very much if we are still to have statistically sound data. The stratified sampling design, especially as improved for the 1994 TCMP, is already allowing considerably smaller samples than would an unstratified random sample of audits. As I noted before, compliance on one line item is generally not highly correlated with compliance on other line items, so an adequate sample of compliance and noncompliance on each line item requires quite large overall samples. Also, some types of important noncompliance are rare and unpredictable from available data: large samples are needed to increase the probability of including these often large but rare cases of noncompliance. Moreover, the factors related to various types of noncompliance vary considerable across categories of tax-

^{7.} Lest the analogy be misunderstood, let me note that the primary reason why the compliance hose is leaky is not that the tax system is old or brittle. More fundamentally, the leaks occur because the financial and social situations of tax entities are complex and forever changing, resulting in both intentional and unintentional noncompliance; because some entities will try to take a "free ride" when the opportunity exists; and because for some the utility and satisfaction of keeping a dollar away from the government is worth more than a dollar.

payers. As a consequence, we must have adequate samples within these categories to permit stable estimates at the level of detail needed for audit selection models and other types of analyses. The added focus on geographically specific analyses by the DORA sites is in many respects a significant improvement, but it does add another cross-cutting dimension for stratifying the population of returns and may increase the total sample size needed.

Burden on Taxpayers. Audits, undertaken for whatever reasons, are burdensome and anxious experiences which taxpayers would like to avoid. TCMP audits differ from other general audits because there is a higher probability that the audit will result in no change or a refund. On the other hand, many returns selected through the sampling process end up with taxes owed even though there was no indication ahead of time that there would be noncompliance. In that respect, all TCMP audits are enforcement audits.

Is the burden in principle excessive or unreasonable? Here I think my analysis of Oregon state audits is relevant. Most of the audits I studied were general audits that routinely included deposit analyses or other indirect methods for checking income. In many cases, tax-payers were also asked to complete a form with estimates of their annual personal and household expenses. Audits that began with one focus frequently expanded to other issues and to other years' returns. Not unlike TCMP audits by the IRS. Did taxpayers in Oregon consider them to be burdensome? Yes. But the vast majority we interviewed did not consider them unreasonably burdensome and, by and large, the taxpayers came out of the audits feeling satisfied with the process and how they were treated and satisfied with the outcomes.

From this analysis and other research on citizens' responses to enforcement experiences, I am convinced that the primary focus in improving taxpayers' responses to TCMP audits should be on assuring that the auditors appear competent, efficient, and reasonable; treat the taxpayers with respect and dignity; keep the taxpayers informed on the progress of the audit; and explain both the process and the decisions in clear and understandable terms. Without assuring the quality of these fundamental fairness aspects of the process, some taxpayers are going to continue to be alienated and resentful, even if they are paid. In short, I am not persuaded that paying taxpayers is necessary, and I am concerned that payment without assuring quality may have unexpected and not necessarily beneficial consequences.

Yes, there are cases of excessive and unreasonable requests from auditors doing TCMP audits. For instance, even in a general audit focusing on all relevant aspects of a taxpayer's financial situation, there seldom is a need for a wedding certificate to verify that a couple with children and grandchildren can be filing a joint return. But I think thoroughness and a focus on the finances of a taxpayer, not just on what appears problematic on the return, is reasonable in any audit—provided the audit is done responsibly and with respect and consideration for the taxpayer.

As is well known at least anecdotally, many auditors resent doing TCMP audits, and the normal criteria for evaluating performance and allocating work in Examinations reinforce the feeling that TCMP audits are also an unreasonable burden on auditors. I suspect that many of the horror stories about taxpayers' experiences can be traced to what can be called "over-conformity" and excessively going by the book on the part of resentful and alienated auditors. In social science and medical research, there is always a concern about the quality of data one can obtain from "hired-hand help" who do not understand and are not committed to the goals and procedures of the research. In improving TCMP, more attention needs to be placed on assuring that auditors are not alienated, hired-hand help. They are the lynchpin of the program and have to be committed team participants.

Some Suggestions for Possible Improvements

In light of these observations about the issues surrounding TCMP, let me briefly suggest some possible improvements. All have been suggested before by experts inside and outside the Service, and I think they are worthy of a serious and open-minded appraisal of their possible advantages and disadvantages.

Specialists in TCMP Audits. Examinations is increasingly moving toward various types of specialists and specifically focused teams. These specialists often become resources for oth-

ers within Examination. Given the specialized nature of TCMP audits and their dual purposes of enforcement and research, there perhaps should also be TCMP specialists. These specialists could be affiliated with the DORA sites while still funcitoning within Examination, and they could serve as liaisons and research resources within Examination at the district or post-of-duty level Correspondingly, the criteria for evaluating their performance and for advancement would have to be broader and somewhat different from the criteria for normal Examination staff. In the funding for these specialists, there probably should also be some recognition of their dual affiliation and multiple roles so that Examination would not, quite reasonably, feel it was paying out of its budget for services to other areas of the IRS and to other government offices. Without some such organizational change, there are going to be continuing structural and incentive pressures toward alienated, hired-hand work on TCMP audits.

Smaller Annual Samples. There are several arguments for moving from large samples drawn every few years to smaller samples drawn every year. The work loads of the TCMP specialists I just suggested would be evened, and there would be other efficiencies in avoiding cycles of starting up and closing down. Moreover, new patterns of noncompliance could be identified and analyzed sooner, and the data would be available on a more timely basis. For some broad stoke analyses and early warning systems, the annual data could be used. For audit selection models and most other detailed analyses, the annual data could be grouped into 3- or 4-year moving clusters. One difficulty with this design is that the data from some years would have to be adjusted for tax law changes before the analyses were performed, and there would inevitably be some additional estimation involved. However, under current procedures, the audit selection models are having to be adjusted after the fact for tax law changes, also with estimations, but with no data on how taxpayers are actually responding to the changes. With annual samples we would at least have some early evidence on these response changes.

TCMP and Basic Tax Reform

Finally, questions have been raised about how TCMP relates to some of the fundamental changes in our federal tax system that are currently be developed and debated. Regardless of the tax system, there will always be a need to monitor compliance, to analyze the factors affecting it, and to evaluate administrative and legislative changes in light of the compliance data. As many of us have argued, measuring and analyzing compliance effectively and accurately will require some sort of probability sampling that is independent of the expected level of compliance and general audits covering the relevant aspects of taxpayers' financial situation: In short, there will always be sound administrative and legislative need for something like TCMP.

Many of the tax reforms being suggested still involve the reporting of income. Currently, most noncompliance, both in terms of the number of taxpayers and the number of dollars, is on the income side, not on the subtraction side. These compliance problems will not completely disappear by eliminating the subtractions and simplifying the returns. Analyses of the current TCMP data about under reporting various types of income and the factors affecting it could be used to evaluate the compliance implications of the alternative reforms.

Those reforms focusing on consumption, especially those involving a VAT or other sales and transaction taxes, will rely upon the accurate reporting and collection of taxes by some sectors of the economy that are now among the least compliant (again, in many cases unintentionally so) and with some of the worst record keeping relative to business needs. Careful analyses with TCMP and other data about possible compliance problems with the reporting and collection of consumption and transaction taxes should be done before the federal government decides to rely primarily on such sources of revenue.

In summary, regardless of the shape of future tax reform, the concern with TCMP now and for the foreseeable future should be on how to improve the program and how to utilize its data more fully in planning and evaluating legislative and administrative reforms. The focus should not be on abandoning the program or its essential characteristics.

This concludes my prepared statement. I would be pleased to respond to any questions.

Mr. HANCOCK. Thank you, Dr. Smith.

The gentleman from Texas.

Mr. LAUGHLIN. Thank you, Mr. Chairman.

Mr. Scheuren, in your testimony you contended that the market segment stratification is a good idea, but not fully tested. Has there not been some market segment analysis of data from prior TCMP studies that supports the value of such data from a larger sample?

Mr. Scheuren. I think the market segment is a very good idea. The problem is at the point of sampling, how good a classification of the taxpayer can you do in terms of market segments? There are some real data quality problems on the tax returns that are being used to do the sampling.

It is a well-known problem. A problem I actually worked on when I was in the Service. At the point of sampling, there is a lot of pos-

sibility for misclassification.

That is one of the reasons why I recommended the additional

work of drawing a subsample.

Mr. LAUGHLIN. Ms. Long, you have indicated that there are numerous approaches to address IRS concerns about the release of current TCMP microdata. Could you give some samples of the issues and the means of addressing them?

Ms. Long. Well, for example, IRS does release TCMP to outsiders under contract with the IRS. You sign a disclosure agreement with some restrictions. They might consider, in the short run, such a proposal so that they could release data for purposes of research. Their concerns, as I understand them, which I think are somewhat misplaced, are that if you had the data you could recreate their discriminant function formulas.

I think if you gave the data to 10 statisticians, you would get 10 different sets of formulas. I do not think this is a real concern, but if that was a concern they could have contractual arrangements so

that people agreed not to do certain things.

I also think that there are some statistical ways that the data could be sanitized that could provide protection against those kinds of concerns with some of the new modern techniques that are available. Right now, TCMP, although we invest a lot of money in it, the actual use of TCMP is disappointing. Also, IRS tends to be rather insular in its approach. We need, I think, a wider commu-

nity looking at it.

Mr. LAUGHLIN. Dr. Long, and Dr. Scheuren, I apologize for not acknowledging your academic achievement. Dr. Feinstein, in your testimony you question the need to expand the household component of the TCMP. Yet, you describe prior TCMP as thin for certain groups and locales. Are there any differences in compliance based on different parts of the country and, if so, are you saying that the differences are not substantial enough to warrant the additional audits, or that the past number of audits provide reliable data for the selection of returns at the local level?

Mr. FEINSTEIN. In my experience, looking at the past data, you would find in narrow cells of taxpayers, for example, farmers in a particular State or lawyers in a particular State, perhaps 1 dozen

or 2 dozen TCMP audits.

I would say that that is, as a statistician would tell you, just about at the level at which you can have some reliability in what

you do. I would never want to go below that but I would not necessarily see that the value of going above that would be as great

as maintaining at that level.

Mr. LAUGHLIN. Dr. Smith, you indicated that the TCMP covers answers to more questions than the IRS research division can explore. Would you recommend that sanitized data be made available to outside researchers as well as to the district office research sites?

Mr. SMITH. I am an outside researcher, I would love to have the data, but I think that the initial focus probably is on getting up to speed more of the sites at the district level within the Service for taking advantage of the data.

I would say that institutionally that should be the focus because

getting more people—

Mr. LAUGHLIN. Well, let me just interrupt you and ask on that point. You stated more needs to be done to get up to speed and I take it you are talking about the TCMP process. What are your rec-

ommendations, specific recommendations for doing that?

Mr. SMITH. I am thinking about the analysis of it. At the DORA level, the analyses could now be done with modern computers with a reasonable level of training and data analysis. Even more critical, perhaps, is also an understanding of the technical problems of analyzing data from audits. Presumably, IRS personnel have some of that sensitivity.

Getting that ability out, at the district level in the new DORA sites, could increase the understanding of approaching problems in an analytical way throughout the Service. That would have a major

advantage.

Yes, there would be considerable advantage in getting more outside researchers interested in studying patterns of compliance and noncompliance by giving out sanitized data. To extend just a bit on what Dr. Long said, a recent study in last year's Research Bulletin from the IRS showed that a great deal of the ability of the DIF process to identify targeted taxpayers for auditing is on how the Service manipulates and prepares the data for the analyses. Outside researchers are not going to have that same skill. That skill is based upon decades of working with the data.

Mr. LAUGHLIN. Well, I certainly thank this distinguished panel

of doctors for their appearance.

I yield back to the gentleman from Missouri, the chairman.

Mr. HANCOCK. The chairman would exercise his prerogative on this and that is, Mr. Feinstein, were you stating in your statement that the average return without the DIF assessment was \$1,000 or whether it was \$5,000? I do not know if that is a statement on how good the auditors are or how bad the tax law is. But this hearing is adjourned, thank you.

[Whereupon, at 2:52 p.m., the hearing was adjourned.]

[Submissions for the record follow:]

WRITTEN STATEMENT OF ERIC J. TODER DEPUTY ASSISTANT SECRETARY (TAX ANALYSIS) DEPARTMENT OF THE TREASURY SUBMITTED TO THE WAYS AND MEANS OVERSIGHT SUBCOMMITTEE IN CONNECTION WITH HEARING ON IRS'S TAXPAYER COMPLIANCE MEASUREMENT PROGRAM JULY 18, 1995

Dear Madame Chairman and Members of the Subcommittee:

I am happy to submit this statement at your request regarding the ways in which Treasury's Office of Tax Policy (OTP) relies on the data compiled in the Internal Revenue Service's (IRS's) Taxpayer Compliance Measurement Program (TCMP) audits. The principal purpose of the TCMP audits is to develop information that will enable the IRS to administer the tax laws more effectively. IRS is solely responsible for the timing, scope, and design of the TCMP audits. But the information the audits produce is also helpful to OTP for both policy analysis and revenue estimation.

From a policy perspective, TCMP audits provide OTP with valuable information on those aspects of the Federal tax system that create the greatest problems of compliance for taxpayers and administrative problems for the IRS. TCMP audits indicate which items of income, expense, deduction, or credit generate the greatest numbers of errors per response. Such errors can occur either because the specific tax provisions associated with those items are unduly complex and confusing for taxpayers, because they are difficult for the IRS to verify, or both. The TCMP data can thus be very helpful to OTP in suggesting policy changes that reduce taxpayer burden and improve compliance. From an estimating perspective, TCMP audits provide useful information on how proposed changes in information reporting or in the level of resources devoted to tax administration would affect future tax receipts.

Treasury's Office of Tax Analysis (OTA) evaluates numerous proposals to improve taxpayer compliance and the ability of IRS to enforce the tax laws. In estimating the revenue impact of these proposals, it is first necessary to establish a "baseline" of the level of non-compliance. The TCMP is the only source of data that provides sufficiently detailed information on the level of compliance associated with specific tax provisions. For example, the Energy Act of 1992 required buyers who deduct seller-financed mortgage interest to report the name and social security number of the seller. The revenue estimate for this proposal required two key pieces of information: (1) the degree of non-compliance in reporting home mortgage interest deductions associated with seller-financed mortgages and (2) the extent to which the IRS could expect to close this gap by requiring the additional information. TCMP data on the level of non-compliance for seller-financed mortgages and on the level of compliance for mortgages financed through financial institutions that currently required information reporting were used to estimate the revenue gain from the proposed increase in reporting requirements.

Another example of the use of the TCMP data in estimating the revenue effect of tax compliance initiatives is the provision of the Omnibus Budget Reconciliation Act of 1993 which required donors to obtain substantiation from donee organizations for charitable contributions of \$250 or more. The provision required a charitable organization to state the

size of the contribution made by the donor and provide a good faith estimate of any goods and services rendered in exchange for the contribution. Before this change in the tax law, the taxpayer needed only to have a cancelled check as validation for a charitable contribution deduction. The TCMP data showed that charitable contribution deductions are frequently and substantially overstated, and showed how the overstatement of charitable contribution deductions was distributed by size of contributions. These data proved crucial in estimating the effects of alternative proposals to detect overstatement of charitable contribution deductions, including the specific one that became law.

The TCMP data also were very helpful in estimating the revenue effects of requiring mortgage brokers to file information reports to the IRS on the proportion of property taxes paid by the buyer and the seller in the course of a home sale. Previously, it was possible for both the buyer and the seller of the house to claim a deduction for the entire amount of property taxes paid on the house in the year of the sale. While the TCMP data did not directly measure compliance for this specific type of deduction, compliance under this proposal could be inferred from examination of compliance in the reporting of the home mortgage interest deduction, an item whose compliance is measured by the TCMP. Thus, even if the revenue effects of a compliance proposal cannot be estimated directly from the TCMP data, it may be indirectly estimated by using a closely related TCMP compliance-measured income or deduction item.

These are just a few examples of how OTP uses TCMP audit data to determine where additional information reporting would be particularly helpful and in estimating the revenue consequences of such changes. To the extent the quality of the TCMP data is maintained at a level consistent with the primary objectives of the program -- the determination of taxpayer compliance levels, the appropriate allocation of IRS audit resources, and the selection by the IRS of specific tax returns for audit -- the TCMP data will continue to meet OTP's requirements. Conversely, if the TCMP program were reduced or compromised to the point where it no longer accomplishes these objectives of the IRS, OTP's ability to rely on the data would also be adversely affected. Were that to happen, our ability to propose improvements to the tax system and provide accurate revenue estimates would be reduced.

164TH CONGRESS, 1ST SESSION

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Congress of the United States

JOINT COMMITTEE ON TAXATION
1015 LONGWORTH HOUSE OFFICE BUILDING
WASHINGTON, DC 20515-8453
(202) 225-3621

AUG 0 1 1995

Honorable Nancy Johnson U.S. House of Representatives Washington, DC 20515

Dear Mrs. Johnson:

You have requested information relating to how the Joint Committee on Taxation ("Joint Committee") uses the Taxpayer Measurement Compliance Program ("TCMP") files of the Internal Revenue Service ("IRS") in preparing revenue estimates for many tax compliance proposals. This letter contains a brief description of the 1988 TCMP file followed by some examples of how the Joint Committee has used the TCMP data.

The 1988 Individual TCMP contains approximately 54,000 individual tax returns for 1988 that have been extensively audited. These returns were chosen to be a statistically representative sample of the 107 million individual returns filed for tax year 1988. The TCMP examination covers every line item of the tax return. In contrast, routine IRS examinations focus on specific, and generally predetermined, items on tax returns.

The resulting TCMP data set contains both the taxpayer-reported amounts and the IRS examination-recommended amounts. The data are particularly well suited to the analysis of information reporting proposals because amounts reported on information documents can be compared with amounts reported by taxpayers to measure taxpayer reporting compliance. Moreover, the data include verified occupation categories for each tax return. Taxpayer-reported occupation categories are accurately reported on only about one third of individual income tax returns. Verified occupation categories are quite useful for proposals that target specific types of taxpayers, such as independent contractors.

The IRS uses the TCMP information as a planning tool to determine its workload, to understand areas in which taxpayers do not accurately report amounts that the Service believes should be reported and to estimate how much individual income tax should have been paid. TCMP data are also used to develop the system that selects returns for audit. One result of the TCMP-developed audit selection system has been a dramatic decrease in the percentage of audited returns for which no change in tax liability was found.

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Honorable Nancy Johnson U.S. House of Representatives

The Joint Committee uses the TCMP data in preparing revenue estimates. Some examples of these include:

- To segregate the "Other Income" line item into the sources of income reported. The General Accounting Office performed this analysis for the Joint Committee and provided results that were used to estimate gambling reporting proposals.
- To estimate excessive claims of charitable contributions for various information reporting proposals. In particular, TCMP data was used to estimate the charitable contribution substantiation and disclosure requirements included in OBRA 1993.
- To analyze estimated tax payment relief proposals for individuals in disaster areas.
- To estimate the reporting of disability income payments.
- 5) To estimate the reporting of unemployment income payments.
- 6) To estimate real estate and property tax reporting proposals.
- 7) To analyze information reporting of sole proprietor gross receipts, and sources of sole proprietor noncompliance, by line item and occupational category. This information was very useful in estimating both the Administration's Service Industry Noncompliance ("SINC") proposal in 1993 and, more recently, various independent contractor proposals.
- 8) To analyze the relative compliance of different classes of taxpayers for various tax reform proposals.

I hope that this information is helpful to you. If we can be of further assistance in this matter, please let me know.

Kenneth J. Kies



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> > O-1-226

August 1, 1995

Members of the House Ways and Means Oversight Subcommittee United States House of Representatives 1136 Longworth House Office Building Washington, DC 20515

Dear Sir/Madame:

The AICPA appreciates the opportunity to comment on the value of the Taxpayer Compliance Measurement Program (TCMP). We believe that the TCMP is an essential element in the Internal Revenue Service's audit program and should be continued. A TCMP audit is a time-consuming process, both for the taxpayer and the agent, but its benefits outweigh the costs through more efficient tax administration. While these audits impose substantial added burdens on those taxpayers selected, they should help countless other taxpayers avoid an audit completely through the accumulation of statistically valid baseline data.

As you are aware, it has been six years since the last TCMP survey. The TCMP is one of the cornerstones of the voluntary compliance system. In a tax system that requires the filing of a return, and when less than 1% of those returns are audited, the enforcement authority (the IRS) must have a method by which to measure compliance and target enforcement efforts. The TCMP aids the IRS in this goal. With the data provided by detailed "random" audits of a statistical sampling of returns filed, the IRS can hone its enforcement efforts to select those returns for an audit which are most likely to be in noncompliance.

Any cost-benefit analysis of the TCMP audit is speculative, at best. The TCMP began with the examination of 92,000 individual tax returns from tax year 1963. The TCMP survey planned for the 1994 tax year is projected to examine 153,000 returns. For the first time, the sample will be drawn from 28 major market segments, enabling the IRS for the first time, to look at compliance within each market segment, regardless of the type of tax return filed. Of the 153,000 returns selected for an audit, 92,000 are intended to be individual tax returns and 61,000 are intended to be corporate and partnership tax returns. These 92,000 individual tax returns represent fewer than .03% of nonbusiness individual returns and fewer than 1% of business individual returns. Nonetheless, the IRS must take steps to ensure that taxpayer inconvenience is minimized for those selected and ensure that taxpayer selection is truly random. While the taxpaying public at large benefits, the incremental inconvenience to the audited taxpayer is severe, as can be the incremental costs.

Members of the House Ways and Means Oversight Subcommittee

August 1, 1995

One subject of potential concern to us, as practitioners and tax representatives, is the role of "economic reality" or "financial status" questions to be used in the forthcoming round of TCMP audits. We have been in oral and written discussion with the IRS National Office about the potential conflict between information needed for an audit of a tax return and taxpayers' rights of privacy. Questions involving "financial status" that extend outside the four corners of the tax return are appropriate only when an examining agent has reason to believe that there may be unreported income on a return. In the absence of such belief or suspicion, we believe it appropriate to challenge when this line of questioning turns from being an audit tool to an improper invasion of taxpayer privacy. We acknowledge the IRS's need to probe for unreported income, but would urge that taxpayers not have to respond to questions that have at best only a tangential connection to that subject.

If you have any questions or wish to discuss the contents of this letter, please do not hesitate to contact one of the following:

Joseph Cammarata
Tax Practice and Procedures Committee Chair
(703) 352-3850

- or -

Anita L. Horn AICPA Technical Manager (202) 434-9231

Sincerely,

Deborah Walker

Chair

Tax Executive Committee

DW/ALH/kvk

cc: Joseph Cammarata, Tax Practice and Procedures Committee Chair Jeffrey L. Raymon, Financial Status Audit Working Group Chair

STATEMENT OF DANIEL J. PILLA ST. PAUL, MINN.

Madam Chairman and Members of the Subcommittee:

My name is Daniel J. Pilla. I am a tax litigation consultant from St. Paul, Minnesota. For nearly 20 years, I have been actively engaged in the defense of taxpayers' rights. My work focuses in the areas of IRS abuse prevention and cure, taxpayers' rights issues, and problems resolution. Over the years, I have been involved, directly or indirectly, with thousands of cases. I have seen every kind of tax case imaginable, and some that are not imaginable.

I am the author of eight (8) IRS self-help defense books. In addition, I am the editor of two nationally circulated newsletters. One is addressed to the general public. The other to tax professionals. In connection with my work as an author, I have appeared as a guest on more than 3,000 radio and TV talk shows, and currently conduct more than 500 interviews per year. In that capacity, coupled with my consulting work, I talk to about one hundred people per week who face difficulty with the IRS.

At present, I am the executive director of an organization known as the Tax Freedom Institute (TFI). TFI is a national association of tax professionals, including attorneys, accountants and enrolled agents who have dedicated a portion of their practice to defending taxpayers rights against abusive IRS practices. As the executive director of TFI, I am responsible for developing continuing professional education materials to train these tax pros in matters of tax law and procedure. I have taught courses in tax law and procedure having to do with taxpayers rights for numerous professional associations, including the prestigious Penn State Tax Institute.

This statement is submitted on behalf of myself in my individual capacity, on behalf of the Tax Freedom Institute, and on behalf of every American business and individual taxpayer.

One question before this subcommittee is whether the IRS' Taxpayer Compliance Measurement Program (TCMP) provides sufficient research value to the IRS and Congress in the areas of tax administration, taxpayer compliance with the tax laws, and policy analysis as to warrant continuation of the program. Another question is whether the program is overly burdensome to taxpayers selected for such audits.

For reasons I shall elaborate upon in detail, I submit the program should be discontinued. First, the program does not provide adequate, accurate or reliable data to either the IRS or Congress in any of the areas of concern. Second, even if the IRS were able to gather accurate data, history has shown the agency is unable to assimilate or utilize the data it has. And third, the program is so invasive and subject to abuse, taxpayers cannot be adequately compensated for being forced to participate in such a program.

1. The results of TCMP Audits are Unreliable.

The TCMP audit is a grueling line by line examination of the tax return selected. Taxpayers are called upon to prove their names, social security numbers, the names and births of their dependent children, and so on throughout the entire return.

The results of the audits are complied into a sophisticated data base which has many uses. Results are used to determine patterns of non-compliance, to evaluate the IRS' policy and enforcement needs, and to assist Congress in the areas of legislative policy. Another primary use of TCMP data is to formulate the data base used in the Discriminate Function System (DIF).

DIF is a computer program which compares every line of one's tax return with national and regional statistical averages for a person in a given income bracket and profession. Such averages were previously ascertained through TCMP audits. If one's return is out of sync with those tolerances, that return is flagged for a potential face-to-face audit by a revenue agent.

TCMP data are unreliable simply because they are only as good as the audits themselves. The reality is the results of IRS audits are often wrong. For a number of reasons, when IRS examiners report that citizens have erred in the computation of tax liability, they have, quite simply, arrived at erroneous conclusions.

In my nearly 20 years of experience dealing with the IRS and audits, I have seen countless examples of examiner errors. In some cases, the errors are so basic, one must question whether they were in fact intentional. Erroneous audit results grow not only from auditor errors, but from overt acts of tax examiners to bluff and intimidate citizens into accepting audit results which are clearly erroneous. These are just a few examples:

- 1. Where examiners wrongfully claim a citizen has insufficient proof to support an otherwise legitimate deduction and therefore the deduction is disallowed.
- 2. Where examiners wrongfully give an incorrect statement of the law to a citizen regarding a particular tax deduction or tax treatment of an item, leading to the disallowance of such item.
- 3. Where amounts of money transferred from one of the citizen's bank accounts to another (transactions known as redeposits) are double and triple counted by examiners, and therefore a citizen is said to have earned income he did not report on his return.
- 4. Where tax examiners falsely claim that citizens have no, or limited appeal rights from the decision of tax examiners, and therefore have no choice but to accept audit results which are clearly in error.
- 5. Where tax examiners falsely claim that citizens will suffer other or greater penalties if they pursue their right of appeal, and therefore accept audit results which are clearly in error.
- 6. Where tax examiners explain to citizens that the avenue of appeal is lengthy, costly, time consuming and the IRS wins its cases anyway, all the while additional accumulations of interest and penalties stack up against the citizen.
- 7. Where, in certain unusual cases but nevertheless prevalent, tax examiners will claim a citizen can be put into jail if he does not sign and accept audit results which are clearly wrong.
- 8. Where, as very commonly happens, tax examiners will threaten citizens with lien, levy and seizure of bank accounts and property if they refuse to sign and accept audit results which are clearly wrong.
- 9. Probably the single most common reason erroneous audit assessments are recorded against citizens is most citizens are simply unaware of their right of appeal. Upon completion of a tax audit, the IRS mails to the citizen a so-called 30-day letter. The letter contains the Revenue Agent's Report (RAR) which details the changes proposed to the citizen's return.

Citizens commonly mistake the RAR for a bill, which it is not. They do not understand that it is a proposed change to their tax, which

they can appeal. But with lack of understanding of the appeal right or process, and lack of funds to hire a professional, many do nothing. This leads to the issuance of a notice of deficiency, which requires the filing of a petition in the Tax Court within 90 days. If the petition is not filed, the amount of tax claimed becomes assessed without further action necessary on the part of the IRS. In effect, the citizen loses his tax audit case by default.

This is certainly not an exhaustive list of the things that commonly happen to honest, perfectly law abiding citizens during the course of routine face-to-face examinations, such as a TCMP audit. They are, however, a few of the more common examples of what takes place on a daily basis within the realm of tax law administration.

Another very compelling reason why tax audits are often wrong is the fact that tax auditors are poorly trained in the law. We have a tax law that consists of 17,000 pages of law and regulation which was changed more than 100 times just during the decade of the 1980s alone. The pure size, scope and evolution of the law makes it physically impossible for any human to understand its full scope and application.

This problem is particularly troublesome in multi-year audits, which are becoming more and more common. A multi-year audit involves more than one tax year. The IRS may, for example, attempt to examine each of the three open years on one sitting. In fact, in the current TCMP model, IRS will provide its agents with three tax returns for the each TCMP subject. They will be, the return for the primary year, and returns for the two previous years.

Problems arise in such audits when the law treats a given transaction differently in one year than it does in the next. Very commonly, an examiner will treat the transaction the same for all years in question. This makes the resulting examination report correct as to one year, but incorrect as to the next. This despite the fact the it reads identically for both years.

The fact that IRS examiners are poorly trained yet are under pressure to produce results is confirmed by a recent General Accounting Office (GAO) report. In testimony to this subcommittee, Lynda D. Willis, associate director of tax policy at GAO described many problems businesses face in complying with the tax laws. Her testimony described the results of a survey GAO conducted to determine the compliance burden faced by small businesses. See: Tax System Burden, Tax Compliance Burden Faced by Business Taxpayers, GAO/T-GGD-95-42, December 9, 1994.

Among other things, Ms. Willis said:

"The complexity of the code has a direct impact on IRS' ability to administer the code. The volume and complexity of information in the code make if difficult for IRS to ensure that its tax auditors are knowledgeable about the tax code and that their knowledge is current. Some business officials and tax expects said that IRS auditors lack sufficient knowledge about federal tax requirements, and in their opinion this deficiency has caused IRS audits to take more time than they otherwise might.* * * " Ibid, page 3.

The audits not only take more time, leading to more cost for both the agency and the private sector, but they often result in

incorrect conclusions. This leads to the assessment of taxes, penalties, interest which are simply not owed.

Recently, the GAO released the result of a study of the IRS' Coordinated Examination Program (CEP). CEP is designed to audit the largest, most complex corporations. Despite having spent 1,700 staff years to examine 1,700 such corporations, GAO was able to confirm that only 22 percent of the amount of tax proposed through audit was ever collected. See: Tax Policy and Administration, Compliance Measures and Audits of Large Corporations Need Improvement, GAO/GGD-94-70, September 1, 1994.

GAO generally cited two reasons for the tremendous difference in the amounts of tax recommended by examination, versus that assessed and collected. First is the complexity of the tax laws. This factor gave rise to "opportunities for different interpretations" of complex tax law issues. Secondly, IRS encouraged CEP teams to "recommend more taxes in the shortest time possible." This not only makes it difficult to do a complete audit, it makes it impossible to do a correct audit.

While the above mentioned report dealt with complex corporate tax audits, the results are no different in the examination of individual taxpayers, or small business taxpayers. IRS examiners are under the same pressure to close cases, and deal with the same complex and ever changing tax law.

I recently completed my own detailed analysis of the accuracy of IRS' audit results. My study was published by the Cato Institute, on April 15, 1995. Drawing exclusively from IRS' annual reports of the Commissioner, I present data which shows that IRS' audit results are consistently wrong about 50 percent of the time. See: Cato Institute Policy Analysis No. 222, Why You Can't Trust the IRS, April 15, 1995. These findings are more generous than the 22 percent found by the GAO in above-cited report. However, they are deeply troublesome from the standpoint of individual citizens.

Individual citizens certainly cannot afford the kind of legal and accounting talent available to America's largest corporations. As a result, citizens are far more likely to fall victim to erroneous statements or out-right bluffs. They are far less likely to exercise their right of appeal, which almost always leads to a more accurate result than is reached by tax examiners.

The reason for this is Appeals officers are under strict guidelines to settle cases solely on the basis of the law and facts. Incredibly, tax auditors are under no such admonition. On the contrary, they are under pressure to recommend taxes and close cases, regardless of the law and the facts. See Revenue Regulation 601.106(f)(1) regarding appeals settlement rules; compare with Revenue Regulation 601.104(a)(1) - (a)(4), regarding examination of returns.

This reality leads to audit assessments which are plain wrong about half the time. The results of TCMP audits are no more accurate than any other type of IRS examination. In fact, given that every line the return is relentlessly examined, I believe TCMP audits are more susceptible to error.

Given the IRS' error rate in the conduct of audits, it is unreasonable to continue to subject the American people to the hassle, significant expense, time and anxiety of TCMP audits. The IRS is aware of the problems it faces with regard to examiner training. The agency recognizes that constant changes to an already confusing law makes it virtually impossible for examiners with the best of intentions to apply its countless facets correctly.

In the face of this reality, the only reasonable thing to do is discontinue TCMP audits and redirect the expense to examiner training.

2. The IRS is Unable to Assimilate or Use the Data it has.

Even assuming the IRS is able to obtain accurate data through the TCMP process, the facts indicate the agency is incapable of putting the information to good use.

Over the years, the GAO has uncovered deplorable deficiencies in the IRS' own internal system of recordkeeping and accounting. These are just a few of the facts:

- a. Weaknesses, oversights and failures in the administration of the IRS information systems substantially increase the risk of fraud and seriously undercut the reliability of data used in management decisions. GAO/AIMD-93-34, September 22, 1993.
- b. The IRS lacks any degree of accountability over its automated data processing equipment. Despite having spending billions on ADP equipment in the process of modernizing IRS computers, the agency cannot account for what it has, how the equipment is used, its value, etc. GAO/AIMD-93-24, August 5, 1993.
- c. The first audit of the IRS' financial statements showed, among other things, the incredible fact that the agency was unable to account for 64 percent of its entire 1992 Congressional appropriation. The report also revealed numerous examples of fraud, malfeasance and nonfeasance on the apart of IRS employees changed with the duties of keeping the agencies books and completing its financial reports. GAO/AIMD-93-2, June 30, 1993. See also GAO/T-AIMD-93-4, August 3, 1993 (testimony of Charles Bowsher, Comptroller General of the United States).
- d. IRS was unable to correctly account for its receivables ledger. Serious problems were found in that IRS could not justify the entries claimed to be accounts receivable. Many were based upon erroneous assessments, uncredited payments, etc. GAO/AFMD-93-42, May 6, 1993.
- e. Audit of IRS' 1993 financial statements revealed ongoing, systematic problems with the agency's accounting practices. Audit findings show the IRS is simply unable to keep accurate books and records of account. These findings are similar to those set forth in paragraph (c) above. GAO/AIMD-94-120, June 15, 1994.

But there is even more compelling evidence of IRS ineptitude, specifically in the area of its enforcement programs. This is directly relevant to the question of TCMP audits.

The GAO has specifically found that the IRS' estimates of revenue generated from its enforcement programs are simply unreliable. The agency does not support its estimates with any facts that allow GAO's auditors to verify them. In the words of the GAO, "* * *In fact, however, IRS does not know how much revenue its enforcement programs actually generate." Tax Policy and Administration, IRS Needs More Reliable Information on Enforcement Revenues, GAO/GGD-90-95, June, 1990 (emphasis added).

In sum, the IRS makes glowing statements concerning the value of its enforcement programs, including TCMP, but in realty, it has no clue whether the programs ever produce the intended results. When we couple the IRS' fundamental lack of recordkeeping with audits we know are incorrect, we must conclude that TCMP audits are simply

worthless in developing the data needed for effective tax law administration.

In recent testimony before a House Appropriations Subcommittee, Jennie S. Slathis of GAO described the problems found in verifying the accuracy of IRS' enforcement initiatives. She states as follows:

"* * *According to the IRS, the revenue data to be used in measuring the success of the compliance initiatives is to come from the Enforcement Revenue Information System (ERIS) -- a relatively new system designed to account for actual collections resulting from IRS' enforcement programs and to enable IRS to more accurately measure and predict enforcement costs and revenues. ERIS is not fully operational, but IRS believes it will be by the end of the year.

"We have some concerns about the reliability of IRS' ERIS data. Those concerns derive from an October 1993 IRS Internal Audit report which says, in part, 'information in ERIS reports is still not accurate, reliable, or consistent.'* * *" Tax Administration, Tax Compliance Initiatives and Delinquent Taxes, GAO/T-GGD-95-74, February 1, 1995.

The GAO reports cited above, taken as a whole, all point to one, inescapable conclusion: The IRS is itself unable to keep books and records or prepare financial statements. It is unable to do the very things it asks every taxpayer to do.

Since the IRS is incapable of tracking something so basic as its accounts receivable, how can it be expected to assimilate and use the complex TCMP data? Since the IRS cannot provide accurate information to Congress on the success of its various enforcement programs, what good are TCMP data, even if they are valid? Since the IRS cannot even keep track of its ADP equipment, how can it be expected to track and use TCMP data? Since IRS cannot account for 64 percent its Congressional appropriation, what right does the agency have to ask any citizen to justify the entries on every line of every tax form filed with his return?

In the concluding remarks to its report on the examination of the IRS' 1993 financial statements, the GAO makes this chilling, and very relevant statement:

"Further, IRS' lack of fundamental recordkeeping is inconsistent with recordkeeping requirements placed on taxpayers in support their returns and has far reaching implications, not only to IRS' credibility as the government's tax collector, but also on the federal government as a whole to responsibly use taxpayers funds. The IRS has more direct contact with the public than most government agencies and, as a result, the public's perception of the federal government as a whole is, in many cases, based on its interactions with the IRS. If IRS does not continue to improve accountability for its financial operations, its credibility could be diminished, reducing voluntary compliance by

taxpayers." GAO/AIMD-94-120, June 15, 1994, page 38.

The question this Subcommittee should be asking is not whether the IRS should be allowed to conduct TCMP audits of honest citizens. This Subcommittee should be asking why it is the IRS, the government's tax collector, cannot comply with even the most basic recordkeeping and data reporting requirements it expects of every citizen.

All the data in the world is of absolutely no value to an agency which cannot record, assimilate or use it correctly.

3. TCMP Burden on Taxpavers.

The government bears a direct responsibility to administer the laws in a fashion which creates the least amount of burden for its citizens. Each year, it seems Congress heaps more information reporting requirements, new tax forms and more recordkeeping requirements on the average citizen in order to comply with tax laws. As the law becomes more cumbersome and complex the cost of compliance for all, including the IRS, goes up. TCMF unreasonably adds to the cost of compliance for many citizens.

TCMP selections are made on a completely random basis. Those selected are not chosen on the basis of any objective criteria. They are not suspected of making any errors. They are not suspected of cheating. Yet they are forced to undergo the most grueling kind of audit.

They must endure endless hours of preparation, copying records and reconstructing their financial activities. They must take time from work and family at their own expense to comply with an endless list of requests and questions served upon them by the examiner, only to face a new list when that one is satisfied. In many cases they must hire a tax professional to represent them. Fees for services run from \$100 to \$300 per hour. A professional's time in connection with a TCMP audit can run to 40 hours or more, depending upon the complexity of the case.

Many citizens have described the TCMP audit as a kind of rape. The agent makes repeated, sometimes unreasonable demands for information, rummages through every aspect of a person's life, drags the ordeal on month after month, and creates substantial expenses in the process. At the same time, the individual agent is not likely to understand the law he is enforcing. After all is said and done, his results are likely to be wrong.

We must ask the question, what is the point?

TCMP audits often delve into areas which are not necessarily shown on the tax return. For example, citizens are called upon to prove the income declared in the return is correct, but must do so with evidence which goes beyond bank statements and W-2 forms. To do this, the IRS often uses Form 4822, Statement of Annual Personal Estimated Living Expenses. Since one's personal living expenses are not an item in the tax return, most citizens keep no records of such expenses, including things like clothing, food, hair cuts, gifts, etc. Yet Form 4822 ask a citizen to reconstruct and report all such expenses.

If one is undergoing an audit of, say, tax year 1993, during the year 1996, he is asked to "remember" what he spent on hair cuts and the like in order to provide an "accurate" picture of his spending habits to the agent. From this "accurate" information, the agent then ascertains whether the citizen's claimed income was sufficient

to support those living expenses. This kind of "examination" is one reason the IRS' audit results are so often wrong.

TCMP audits are deeply invasive. They involve unearthing the most private aspects of a person's life. These are the kind of things the FBI or local police could never get access to without a search warrant. Yet the IRS merely demands the material and expects compliance under penalty of law. Citizens who have done nothing wrong are made to feel like criminals. Since the burden of proof in all matters is upon the citizen, not the IRS, they find themselves having to prove their innocence as to every line of the tax return.

I believe and assert there is much more to the TCMP audit than IRS is willing to tell. We know it cannot be simply a matter of data. The agency cannot correctly use the data it has. I believe the real issue is one of "presence."

For the years, the IRS has expressed the desire to "create and maintain a sense of presence" in the lives of all Americans. This idea was clearly expressed in a 1984 document entitled, Strategic Plan, IRS Document No. 6941. Creating "presence" means building the notion in the minds and hearts of all Americans, that the IRS is "watching you." The IRS insisted in its 1984 plan that creating presence was vital to "encouraging voluntary compliance."

More than anything else, TCMP is about creating presence. In this context, the results of TCMP audits are irrelevant. The data gathered is inconsequential compared to the enforcement gains achieved by persuading every American that the IRS is "watching you." This amounts to psychological warfare waged by the government of the United States, through the IRS, on its own citizens.

To the extent that TCMP is an integral part of the effort to "create and maintain presence," the undertaking is outrageous, especially in light of all the forgoing.

Given the IRS' lack of ability to do the same with regard to its own financial matters, it is unreasonable to lay those burdens at the feet of the American people.

4. Why Voluntary Compliance is Declining.

IRS maintains the reason TCMP is so necessary, is that voluntary compliance is in decline. IRS insists it needs TCMP data to understand the treads, to be able to deal with the enforcement problems of the day.

I can tell this Subcommittee in one sentence why voluntary compliance is in decline. I can explain very simply why the tax gap continues to grow, despite every enforcement program ever funded. I can explain why the number of tax return nonfilers is growing along with the underground economy. I know because I deal with these people every day. I listen to their stories. I help them through their problems.

The reason for the drop in voluntary compliance is very simple. More and more Americans are simply unable to pay the taxes they owe. Federal, state and local tax rates now consume more than 40 percent of a person's gross income. More citizens every day are forced to make a choice between paying their taxes and feeding their families. One in such a position will opt to feed the family every time -- without question and without hesitation.

To solve the problem of voluntary compliance, we must conquer the federal government's insatiable demand for more revenue. If revenue demands do not stabilize, then shrink in relationship to individual

expenses, no amount of enforcement programs or compliance initiatives will ever solve the problem. Congress must simply face the fact that it is spending too much of our money.

At the same time, we must pursue a course of radical tax reform. As evidenced by the GAO reports cited in this testimony, our system cannot possibly continue to operate under the status quo. The IRS, in its opinion, will never have enough information to enforce the law. It will never have enough money, manpower or equipment to administer the law. Yet we cannot, it seems clear, continue to allow the agency to grow in size, power and sweep, given its deplorable record of unaccountability on matters so basic as its own financial affairs.

Ultimately, to solve our nation's tax problems, we must abandon the IRS and the income tax system altogether. We must move to a system which is not dependent upon knowing the intimate details of every citizens' private life in order to collect the revenue needed to fund the government. We must move to a system which does not require 120,000 IRS employees and a budget of \$8.2 billion to administer. We must adopt a system which frees us of the requirements to file 210 million tax returns and 1.3 billion information returns annually. We must develop a system under which the American people will no longer have to chose between paying their taxes and feeding their families.

It is my considered opinion that only a national retail sales tax can accomplish all those things. I believe time has come for Congress to stop discussing bandaide treatments for a hemorrhaging patient.

Thank you.

IRS BUDGET FOR FISCAL YEAR 1997 AND THE 1996 TAX RETURN FILING SEASON

HEARING

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT

COMMITTEE ON WAYS AND MEANS HOUSE OF REPRESENTATIVES

ONE HUNDRED FOURTH CONGRESS

SECOND SESSION

MARCH 28, 1996

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IRS BUDGET FOR FISCAL YEAR 1997 AND THE 1996 TAX RETURN FILING SEASON

THURSDAY, MARCH 28, 1996

HOUSE OF REPRESENTATIVES, COMMITTEE ON WAYS AND MEANS, SUBCOMMITTEE ON OVERSIGHT, Washington, DC.

The Subcommittee met, pursuant to notice, at 10:14 a.m., in room 1100, Longworth House Office Building, Hon. Nancy L. Johnson (Chairman of the Subcommittee) presiding.

[The advisory announcing the hearing follows:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

SUBCOMMITTEE ON OVERSIGHT

FOR IMMEDIATE RELEASE March 19, 1996 No. OV-11 CONTACT: (202) 225-7601

Johnson Announces Hearing on Internal Revenue Service Budget for Fiscal Year 1997 and the 1996 Tax Return Filing Season

Congresswoman Nancy L. Johnson (R-CT), Chairman, Subcommittee on Oversight of the Committee on Ways and Means, today announced that the Subcommittee will hold a hearing on the Internal Revenue Service's budget proposal for fiscal year 1997 and the 1996 tax return filing season. The hearing will take place on Thursday, March 28, 1996, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 10:00 a.m.

In view of the limited time available to hear witnesses, oral testimony at this hearing will be heard from invited witnesses only. However, any individual or organization not scheduled for an oral appearance may submit a written statement for consideration by the Subcommittee and for inclusion in the printed record of the hearing.

BACKGROUND:

The Administration's fiscal year 1997 budget request for the Internal Revenue Service (IRS) totals almost \$8 billion and will support the IRS's operations in collecting nearly \$1.5 trillion in revenue and in administering the Federal tax laws. By way of comparison, the fiscal year 1996 appropriation for the IRS totaled \$7.3 billion, approximately \$900 million less than the Administration had requested and \$200 million less than the IRS received for fiscal year 1995.

The \$8 billion fiscal year 1997 budget request includes \$1.8 billion to process the tax returns which taxpayers will file in 1997; \$4.5 billion to examine tax returns; and \$1.7 billion for information systems. Almost \$850 million of the information systems request is earmarked for the Tax System Modernization (TSM) program. TSM is a long-term program which is estimated to cost over \$8 billion upon completion, and which is supposed to upgrade the IRS's computer capability and bring it closer to state-of-the-art performance levels. However, numerous experts who have reviewed TSM have criticized the IRS's ability to successfully implement TSM in its current form.

The 1996 tax return filing season is the period of time between January and April 15th when American taxpayers are expected to file 118 million tax returns. Approximately 83 million taxpayers are expected to receive an average refund of over \$1,300 in 1996. During the 1995 tax return filing season, the IRS applied rigorous compliance checks in order to identify fraudulent refund claims.

FOCUS OF THE HEARING:

As a result of the reduced level of the fiscal year 1996 appropriation, the IRS must absorb a \$200 million funding reduction during the current fiscal year. The Subcommittee is interested in reviewing how the Service is adjusting its operations to comply with the reduced funding, and how the IRS is retargeting its resources to meet the demands of the 1996 filing season and its other responsibilities in administering the nation's tax laws.

In reviewing the fiscal year 1997 budget request, the Subcommittee will review all aspects of IRS operations, and particularly the TSM program. The Subcommittee will explore the status of specific systems upgrades, such as the Integrated Case Processing system, which will allow IRS taxpayer service representatives to access IRS databases on-line in order to respond to telephone inquiries from taxpayers. The Subcommittee will also review the appropriate level of TSM funding in the future in light of the current restricted funding environment, the critical evaluation of TSM by outside experts, and the Administration's recent testimony that the program is off track and needs to be rethought.

Chairman Johnson is also concerned that the IRS hasn't been able to adequately account for the \$4 billion already invested in TSM. "While I understand that over-hauling the Service's antiquated computer systems is a major endeavor which will require mid-course adjustments, the IRS's learning curve in implementing TSM appears to be very costly. I want to make sure that the \$4 billion spent so far has not been wasted," Johnson explained.

The Subcommittee will also inquire into the progress of the 1996 tax filing season, the availability of taxpayer services, the effectiveness of anti-fraud efforts in the 1995 filing season, and what the IRS is doing in the 1996 filing season to deter improper refund claims.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Any person or organization wishing to submit a written statement for the printed record of the hearing should submit at least six (6) copies of their statement, with their address and date of hearing noted, by the close of business, Thursday, April 11, 1996, to Phillip D. Moseley, Chief of Staff, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements wish to have their statements distributed to the press and interested public at the hearing, they may deliver 200 additional copies for this purpose to the Subcommittee on Oversight office, room 1136 Longworth House Office Building, at least one hour before the hearing begins.

FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

- All statements and any accompanying exhibits for printing must be typed in single space on legal-size paper and may not
 exceed a total of 10 pages including attachments.
- Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.
- 3. A witness appearing at a public hearing, or submitting a statement for the record of a public hearing, or submitting witness comments in response to a published request for comments by the Committee, must include on his statement or submission a list of all clients, persons, or organizations on whose behalf the witness appears.
- 4. A supplemental sheet must accompany each statement listing the name, full address, a telephone number where the witness or tie designated representative any be reached and a topical ordine or summary of the comments and recommendations in the full statement. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press and the public during the course of a public hearing may be submitted in other forms.

Note: All Committee advisories and news releases are now available over the Internet at GOPHER.HOUSE.GOV, under 'HOUSE COMMITTEE INFORMATION'.

Chairman JOHNSON. The hearing will come to order.

Some of our Members are en route, but in view of the heavy floor schedule, we would like to get started.

Good morning and welcome. The fiscal year 1997 budget proposal for the IRS would give it almost \$8 billion and almost 109,000 employees in order to collect \$1.5 trillion in revenue. This represents an increase of 10 percent over the 1996 level. I respect the prerogative of the administration to present a budget designed to carry out its priorities; however, I believe that the Congress will have some

tough, legitimate questions about this proposal.

This morning we want to learn how the IRS intends to use its resources in fiscal year 1997. Most IRS programs show only small changes, but a few programs deserve special attention. The budget proposes \$850 million for the Tax Systems Modernization Program. The TSM is supposed to upgrade the IRS' computer capability and move it closer to modern performance levels. It is essential to improve the IRS' computer capability if it is to cope with the crushing burden of processing over 1 billion documents every year, but there are many unanswered questions about the TSM Program at the present time.

No one questions the goal of TSM, but significant doubts have been raised as to whether the IRS is on the right road to achieve its goal. Two weeks ago, Deputy Secretary of the Treasury Lawrence Summers testified before a House Appropriations Subcommittee that TSM had gone "badly off track," and that it "needed

to be rethought from top to bottom."

I certainly understand that a complex computer project might need a midcourse correction, but it sounds as if the IRS is going back to square one on TSM. The question raised by this decision is: What have we gotten for the \$4 billion we have invested so far? How much of the past TSM funding will the IRS now have to just chalk up to experience? How much of that money spent so far has been wasted? And how much of it has gone for something useful and productive? And how long will it take to get TSM back on track?

We don't want TSM to become the IRS equivalent of the baggage handling system in the new Denver airport: High tech, high cost,

low performance.

Today we will examine how the IRS is absorbing the reduced funding in the current fiscal year. We want to learn what the Commissioner's priorities are in operating with fewer resources. Are all the activities being trimmed a similar amount, or are a few activi-

ties bearing the brunt of the reduction?

The 1996 tax filing season appears to be normal and uneventful. This is a welcome contrast to the disruptions which occurred last year because of the IRS' crackdown on fraudulent refund claims. I commend the Commissioner's strong action to identify and deter improper refund claims. But a regrettable side effect was a good deal of confusion and some late refunds.

Commissioner, the IRS is the one Federal agency that touches the lives of every American. How Americans view their government often is determined by how they view the IRS. A large part of the enthusiasm for pursuing a flat tax or a consumption tax is rooted in a negative attitude toward taxes and, derivatively, toward the IRS. The tax collector may never be loved, but it is a sobering message when the average person supports the elimination of the IRS.

My goal is to work with you to modernize the system and assure that the IRS delivers a uniformly high standard of professional service. Because of its tough assignment to help taxpayers who genuinely need guidance and to assure that every citizen pays his or her fair share, whether they want to or not, the quality of customer service, the attitude of every IRS employee as they deal with the public as both guide and enforcer is crucial to restoring respect, civility, and efficiency to government.

While citizens need to know and understand the many important services government delivers day in and day out that do make our lives individually and collectively better, government needs to be far more customer oriented and user friendly, and I hope to work with you toward those goals. Today's hearing to review your 1997 budget request and the current filing season are the beginning of

what I hope will be a fruitful collaboration.

Before we begin, let me thank you, Commissioner, for implementing by administrative action many of the provisions of the Taxpayer Bill of Rights when it looked like we would not get it onto the floor of the House and to the President's desk. I am pleased to report that we expect to have the new bill, which your people have also been involved in shaping, on the floor hopefully this week and very soon to the President's desk.

Commissioner Richardson, it is a pleasure to have you back with

us. Please proceed.

STATEMENT OF HON. MARGARET MILNER RICHARDSON, COMMISSIONER, INTERNAL REVENUE SERVICE; ACCOMPANIED BY MIKE DOLAN, DEPUTY COMMISSIONER; JUDY VAN ALFEN, ASSOCIATE COMMISSIONER FOR MODERNIZATION; JIM DONELSON, CHIEF OF TAXPAYER SERVICE AND ACTING CHIEF COMPLIANCE OFFICER; AND TONY MUSICK, CHIEF FINANCIAL OFFICER

Ms. RICHARDSON. Thank you. Madam Chairman and other distinguished Members of the Subcommittee, I have with me today Mike Dolan, who is on my immediate left, the Deputy Commissioner; Judy Van Alfen, who is the Associate Commissioner for Modernization; and on my right I have Jim Donelson, who is the Chief of Taxpayer Service and our Acting Chief Compliance Officer; and Tony Musick, who is our new Chief Financial Officer. We all appreciate the opportunity to be here this morning to discuss the filing season, our efforts to modernize the tax administration system, as well as our fiscal year 1997 budget request.

The IRS is in the financial services business—like a bank, a credit card company, or an insurance company—and we understand the importance of providing good customer service. Of course, we understand there are some significant differences between our business and other financial services firms. But despite these differences, like many other financial services firms, what we are seeking may be easier to describe than to achieve. We want to provide our customers with better service at lower cost, we want to use less paper, and we want to be able to take advantage of new

technologies.

We are in the midst of a major transition, as I know you are aware, Madam Chairman, but it is one that began several years ago, and it will continue for several more years. Today I would like to focus on what we are trying to do to make things easier for tax-payers, how we are doing our job more efficiently and effectively.

This filing season—and every filing season—begins with taxpayers filling out their tax returns and sending them in either through the mail or electronically. Since coming to the IRS almost 3 years ago, I have made it a top priority to try to improve service to taxpayers. For most taxpayers, this means making communicating with us easier and filing tax returns as simple as possible. While we are certainly not yet at a stage we could call perfection, I do believe in the past 3 years we have made progress in improv-

ing our service to taxpayers.

We understand that taxpayers get frustrated when they call us and repeatedly get a busy signal, and in the past 3 years we have answered more calls than ever before. But we still have taxpayers whose calls are not answered. We also have a growing number of taxpayers who visit or write us. In 1993, we heard from taxpayers by phone, visits, or letters 73 million times. Last year that grew to 118 million. But we were able to serve more taxpayers by increasing our productivity, expanding our hours of service, and installing call-routing equipment that does allow us to better manage our telephone workload. It allows us, among other things, to route calls to available assistors who may be in the next county, the next State, or even across the country. We are doing our best to try to answer more taxpayer questions more quickly and efficiently.

When I became Commissioner in 1993, not only were we unable to move calls around the country, but our assistors only had access to taxpayer account information that was stored at the particular service center their office had to rely on. Technology has allowed us to remove this artificial barrier and to enhance our ability to route calls automatically to personnel who have both the data and the expertise needed to handle taxpayers' specific questions. And we can now resolve issues with a single call 75 percent of the time,

and we are bringing more tax account information online.

But despite these improvements, not every taxpayer call is being answered, and not all taxpayers who need to be served are getting served. So we are looking for other ways to meet taxpayers' information needs.

Technology is certainly helping by creating entirely new ways for taxpayers to get forms and information from us while reducing our postage and printing costs. Taxpayers who have access to a computer and modem can get forms and information anytime anywhere in the world from our FedWorld or our Web site on the Internet. So far this year, millions of taxpayers have visited our Internet home page, and an average of 25,000 forms a day are being downloaded. Forms are also available on CD-ROM and, for the first time this year, through our automated "fax on demand" service.

One of my goals has been to make it easier for taxpayers to file their returns. Today nearly 40 percent of individual filers use our easiest forms, and over 70 percent take a standard deduction. What could be easier than filing by telephone? This filing season, over 20 million taxpayers are eligible to file their tax returns with a phone call that takes less than 10 minutes. As of March 22, over 2.5 million taxpayers have already used this option. Three years ago, our TeleFile Program was a pilot, and just last year it was available in only 10 States and we had only 680,000 returns filed that way.

Making it easier for taxpayers to both file their returns and communicate with us is only part of our effort to improve our relationships with taxpayers. As you mentioned, Madam Chairman, we worked with you and Members of the Subcommittee on the Taxpayer Bill of Rights 2, and I am pleased to say that we were able to work with you on the bill that we hope will be reported out next week and passed. But when we weren't successful in getting the legislation earlier, we did go ahead and administratively adopt many of the proposals that didn't require congressional action.

We look forward to continuing to work with you and Members of your Subcommittee on our continuing priority, which is responsible

tax administration while ensuring taxpayers' rights.

Last year when I appeared before this Subcommittee, I said that our biggest challenge was to put in place better methods to protect the tax revenue from those who improperly attempted to claim refunds. We accomplished this by using both technology and a different approach to compliance to stop improper refund claims. We used numerous systemic verifications, including checks of Social Security numbers. We established new criteria for electronic return originators, including fingerprint and credit checks, and we increased our monitoring of the EROs. We delayed about 8 percent of the refunds, and we did increase compliance resources devoted to checking those refunds for accuracy.

I am pleased to report our efforts were most successful. One-and-a-half million fewer dependents were claimed, and there were approximately 100,000 fewer earned income tax credit claims than in the prior year. In our direct compliance efforts, including prerefund audits, we prevented \$503 million in improper refunds from being

issued.

This filing season we are continuing to devote substantial resources to detecting and stopping improper and fraudulent claims for refund. We have refined our efforts to address improper refund claims based on what we learned last year.

I would also like to spend a few minutes talking about modernizing our current tax administration system. Modernization requires an ongoing effort to update technology, to improve our business processes, and to develop a flexible organization. Today I would like to touch on our efforts to update the technology.

As you pointed out, we have undertaken a series of technology modernization projects, collectively referred to as the Tax Systems Modernization Program, to modernize our information systems. It was originally designed in 1988 as a program to replace our technology. It has been redesigned since then to assist us in achieving our business vision by the year 2000, although many of the projects are scheduled for completion before then, and some, like our TeleFile Project, have already been completed.

Our TSM investments are putting a new infrastructure in place. A number of initiatives are currently underway with substantial long-term benefits. During the past 4 years, we have awarded contracts that upgrade computer center hardware, modernize operations, and allow us to utilize commercial expertise for software and hardware support, information engineering, telecommunications, and security. As of today, about \$1.7 billion in new equipment and software has been installed across the country.

Over the past several years, our technology modernization efforts have benefited from oversight of the General Accounting Office, the National Research Council, and from the Congress. On balance, we agree with the assessments that have been made. We take them seriously but, more importantly, we are doing something about them.

During the past year, management of the Tax Systems Modernization Program has changed significantly. Modernization management has been centralized under the Associate Commissioner for Modernization who has been given all of the responsibility and authority to manage and control consistently all systems development and reengineering efforts within the IRS. We also have a new Chief Information Officer, Arthur Gross, who will be working with the Associate Commissioner for Modernization, and he is joining us on April 15. He was most recently the deputy tax commissioner in New York, responsible for systems and processing in that State. He had led a broad modernization effort in that State for the past several years, and we look forward to having his counsel and expertise.

But a vital aspect of updating our technology is enhancing capabilities for safeguarding taxpayer information. We very much concur with the National Research Council's advice regarding the security of tax processing systems and the privacy of tax information. We are also relying heavily on private sector expertise to assist our technology modernization projects. We have developed a plan with the help of outside experts from other government agencies and the private sector to aggressively expand the work of our current integration support contractor. Under this new approach, the integration support contractor will assume as much of the systems integration role as our current contracts permit. This will include the architecture, systems engineering, integration, and test activities that are essential to successfully integrate the systems.

I would like to briefly touch on our 1996 budget and our fiscal year 1997 budget request. The fiscal year 1996 budget decrease we experienced posed a particular challenge to us since we require about \$200 million more each year for cost increases that are beyond our control, such as pay raises and rent increases, just to maintain the current level of operations. Our current budget allows us to run our basic operations and will not affect the processing of returns or the payment of refunds within our customer service standards of 40 days for paper filing and 21 days for electronic filing during this filing season.

But what we will not be able to accomplish again are the impressive results we achieved in the deficit reduction last year through our compliance initiative funding. We collected an additional \$803 million, more than double the \$331 million we had promised. We

have asked for an increase of \$647 million in our fiscal year 1997 budget. If instead our funding remains flat for 1997, we would experience a real reduction of between \$200 and \$400 million from our fiscal year 1996 funding level because, once again, we would be forced to absorb pay raises and increased costs, and we would be faced with difficult choices.

Like this year, we will continue to make it a priority to sustain our basic operations—processing more than 200 million tax returns and paying more than 90 million refunds. To accomplish this, however, we will, like we did last year, have to find alternative ways to serve taxpayers, and like this year, we will have to decrease the amount of face-to-face contact with taxpayers. While we will continue to process tax returns and pay refunds on time, service to taxpayers may suffer, and the amount of money collected next year could certainly be impacted. What is more difficult to measure, though, is the longer term impact of reductions on overall taxpayer compliance levels.

Madam Chairman, since becoming Commissioner almost 3 years ago, I have worked hard with our staff to try to improve our service. As I said earlier, I am pleased to report we have made significant progress. But despite that progress, we do recognize we still have much to do.

This concludes my prepared remarks, and we would certainly be happy to answer any questions you or your colleagues might have. [The prepared statement and attachments follow:]

STATEMENT OF MARGARET MILNER RICHARDSON COMMISSIONER OF INTERNAL REVENUE

BEFORE THE SUBCOMMITTEE ON OVERSIGHT HOUSE COMMITTEE ON WAYS AND MEANS MARCH 28, 1996

Madame Chairman and Distinguished Members of the Subcommittee:

With me today are Mike Dolan, Deputy Commissioner, Judy Van Alfen, Associate Commissioner for Modernization, Jim Donelson, Chief Taxpayer Service and Acting Chief Compliance Officer, and Tony Musick, Chief Financial Officer. We appreciate the opportunity to be here this morning to discuss the IRS's 1996 filling season, the results of the 1995 filling season, our efforts to modernize the tax administration system, and our FY 1997 budget request.

BACKGROUND

The IRS is in the financial services business — like a bank, a credit card company or an insurance company. We have the same basic processes — collecting money, processing data, maintaining customer accounts, and responding to account questions. Customers expect us to do this accurately and efficiently while maintaining the highest level of integrity and safeguarding their privacy.

Of course, there are some significant differences between our business and other financial services firms. We are also in the law enforcement business -- we are charged with administering and enforcing the tax laws of this country and combating financial crimes. Another significant difference is sheer volume. Compared to other financial services businesses, we have many more customers -- more than 200 million - and we handle much more money -- over a trillion dollars annually. We also operate under different constraints. We cannot modify our product line, and we do not choose our customers. And, of course, we cannot change the laws that govern our operations; they are written by others.

Despite these significant differences, like many financial services firms, what we seek is easier to describe than achieve. We want to provide customers with better service at lower cost. We want to use less paper and take full advantage of new technologies.

Some say that all businesses must learn how to "do more with less." Having thought a lot about how we can do our job better, I believe instead that we must devise innovative solutions to problems. That requires a combination of updated technology, improved business processes and a flexible organization -- the essence of modernization. We are modernizing the IRS on all three fronts.

We are in the midst of a major transition -- one that began several years ago and that will continue for many more years. As I discuss the filing season, our modernization efforts and the FY 1997 Budget Request, I would like to focus on what we are doing to make things easier for taxpayers and how we are doing our job more efficiently and effectively.

THE FILING SEASON - SERVING TAXPAYERS BETTER

The filing season begins with taxpayers filling out their tax returns and sending them, either through the mail or electronically, to the IRS. Since coming to the IRS almost three years ago, I have made it a top priority to improve our service to taxpayers. For most taxpayers, this means making communicating with us and filing returns as simple as possible. While we have yet to reach perfection, I believe in the last three years we have made progress in improving our service to taxpayers.

Making It Easier For Taxpayers

Taxpayers get frustrated when they call us and repeatedly get a busy signal. In the past three years we have answered more calls than ever before, but we still have taxpayers whose calls are not answered. We also have a growing number of taxpayers who visit or write us. For example, in 1993, we heard from taxpayers by phone, visits, or letters 73 million times. Last year, this number grew to 118 million. We expanded

access to our TeleTax recorded information line, which offers taped information on 148 topics all day every day, and refund information 16 hours a day, Monday through Friday. Last year, we answered 61 million TeleTax calls, over twice the 30 million answered in FY 1994. In FY 1995, our assistors also answered 39 million calls, an increase of more than 3 million over the prior year. We were able to serve more taxpayers by increasing productivity, expanding our hours of service, and installing call routing equipment that allows us to better manage our telephone workload. This technology allows us, among other things, to route calls to available assistors, who may be in the next county, next state or across the country. Taxpayers cannot tell the difference, but I hope they are aware of the improved service that results.

We are trying to answer taxpayer questions more quickly and more efficiently. In 1993, when I became Commissioner, not only were we unable to move calls around the country, but our assistors had access only to the taxpayer account information that was stored at the particular Service Center their office relied on. Technology has allowed us to remove this artificial geographic barrier and to enhance our ability to route calls automatically to personnel who have both the data and expertise needed to handle taxpayers' specific questions. Last year, we began providing nationwide access to certain taxpayer account information. As a result, we could resolve issues with a single call 75 percent of the time; and we are bringing more tax account information on-line.

Despite these improvements, not every taxpayer call is being answered and not all taxpayers who want to be served are being served. So we are tooking for other ways to meet taxpayers' information needs. At the outset, that means making the information we do provide so clear that taxpayers will not need to contact us.

We are also reducing the number of notices we send. We recently decided to eliminate notices that are now sent out about 46 million times a year. This is good for both the IRS (we save \$20 million in printing and postage and eliminate subsequent questions) and taxpayers who are relieved of the stress that can surface when an official looking letter from the IRS arrives in the mail. The notices we will continue to send are being rewritten in clearer language so that fewer recipients will require further explanation.

Technology is creating entirely new ways for taxpayers to get forms and information from us while reducing our postage and printing costs. Three years ago, taxpayers requesting a publication or form either had to call us to have the material mailed or they had to drop by one of our offices, their local post office or library. Not today — at least for many taxpayers. Taxpayers with access to a computer and modem can get forms and information anytime, anywhere in the world from FedWorld or our Web Site on the Internet. So far this year, millions of taxpayers have visited our Internet home page and an average of 25,000 forms a day are being downloaded. Forms are also available on CD-ROM, and, for the first time this year, through our automated "fax on demand" service.

We also sponsor VITA, the Volunteer Income Tax Assistance program, and TCE, Tax Counseling for the Elderly. With these two programs we also assist taxpayers by giving them the opportunity to have direct contact at more than 20,000 sites with volunteers trained by IRS personnel. Last year, more than 80,000 volunteers served almost 3.5 million taxpayers through both of these programs.

Easier Filing Methods

One of my goals has been to make it easier for taxpayers to file their tax returns. Current data suggests we're making progress on this front. <u>USA Today</u> recently reported on a poll that showed 52 percent of American taxpayers describe preparing their personal income taxes as easy. The Associated Press also recently reported on a poll that found that 50 percent of taxpayers insist the system is not too complicated for them personally. Nearly 40 percent of individual filers now use the easiest tax forms and more than 70 percent take the standard deduction.

What could be easier than filing by telephone? This filing season, 23 million taxpayers can file their tax returns with a phone call that takes less than ten minutes. As of March 22, 1996, 2.5 million taxpayers have already used this option. Three years ago, TeleFile was a pilot, and, just last year, when it was only available in 10 states, 680,000 returns were filed by telephone.

Beginning in FY 1994, taxpayers could file from their home computers through a third party transmitter. As of March 22, 1996, about 102,000 taxpayers had used this filing method, a significant increase from the 1,000 that filed through this service last year. Also this year, taxpayers in 31 states can satisfy both their federal and state tax obligations with a single electronic transmission, an increase from the 15 states where joint electronic filing was available in FY 1993. As of March 22, 1996, 2.7 million joint Fed/State returns have been filed — more than double the 1.1 million filed last year.

Electronic filing is not just limited to individuals. It is also available to businesses. Employers nationwide can now file their "Employer's Quarterly Tax Return" (Form 941) electronically, and almost 200,000 of these returns were processed for 1995. A TeleFile option for the simpler Form 941 returns is in the works.

Electronic filing offers advantages for both taxpayers and the IRS. Taxpayers file more accurate returns and get their refunds faster, and we receive more accurate information more quickly and eliminate the need for expensive paper processing.

Electronic commerce means more than just receiving returns electronically, it includes electronic payments as well. Most of the more than 90 million taxpayers getting refunds this year can have them directly deposited into their bank accounts. Taxpayers enjoy the safety and ease of direct deposit, and we save the expense of printing and mailing checks.

The TaxLink/Electronic Funds Transfer Payment System, used by employers to pay employment and other depository taxes electronically, is faster, easier and more accurate for tax collectors and taxpayers alike. In FY 1995, more than \$232 billion was deposited electronically, a major increase over the \$6.2 billion deposited in FY 1994.

Despite these new electronic options, the number of paper tax returns filed has increased since 1992. The good news is that the staff needed to process these returns has decreased, and in the past three years we have realized a productivity improvement of 12.4 percent in processing paper returns.

We are also using other ways to process tax payments. By directing many payments to bank lockboxes, whereby banks process payments and credit them to the Treasury Department, the deposit process has been accelerated and accuracy has been increased. In FY 1995, over \$125 billion went through the lockbox payment system, an increase of \$18 billion over the prior year.

Taxpayer Bill of Rights 2

Making it easier for taxpayers to both file their returns and communicate with us is only part of our effort to improve our relationships with taxpayers. During the last year, we have had the opportunity to work with you, Madame Chairman, and Members of this Subcommittee on the Taxpayer Bill Of Rights 2 (TBOR 2), and I was pleased to learn that the legislation was reported out of the Ways and Means Committee last week. When last year's efforts to enact TBOR 2 were not successful, working together with this Subcommittee, we administratively adopted the proposals that did not require Congressional action.

In January 1996, we published Announcement 96-5, entitled "Administrative Actions to Enhance Taxpayer Rights", to identify the TBOR 2 proposals that the IRS had either already adopted or could adopt administratively with no legislative action. The Announcement also included IRS regulatory and guidance projects that were similar in nature to the TBOR 2 proposals developed by the Committee.

As a result of this approach, the IRS has been able to provide taxpayers with some of the benefits of TBOR 2 until legislation can be enacted. For example, the IRS has already taken steps to strengthen the role of the Taxpayer Ombudsman in the IRS. The IRS has limited the number of IRS officials who can overrule a Taxpayer Assistance Order ("TAO") to only the Commissioner, Deputy Commissioner or Ombudsman. The IRS also clarified that the Ombudsman may issue a TAO to direct the IRS to pay a refund to a taxpayer to relieve a severe financial hardship and to stop a collection action to ensure review of whether the action is appropriate. The Ombudsman now also has greater power over the selection and evaluation of local Problem Resolution Officers. Finally, the Ombudsman is now required to prepare annual reports on the most serious taxpayer problems and suggest administrative and legislative solutions to those problems.

The IRS has underway two studies: one that is of particular interest to you, Madame Chairman, is on the unique problems faced by divorced and separated taxpayers under the current tax system; the other is on interest netting. To help us with these studies, we issued two Notices last week asking for public comment on issues that may arise in each of these situations.

The IRS has also issued guidance to Revenue Agents and Revenue Officers on new procedures to notify one spouse of actions taken against the other spouse to collect their joint taxes. On April 1, 1996, the IRS will put into place procedures to give taxpayers the right to appeal liens, levies and seizures proposed by the IRS. The IRS has already trained its personnel in this new Appeals procedure. And, we formalized our practice of requiring Regional Counsel to review designated summonses and limiting designated summonses to large (Coordinated Examination Program) cases, except in unique circumstances.

We also helped taxpayers by adopting a number of alternative dispute resolution initiatives, such as an Appeals mediation procedure, simultaneous Appeals/competent authority procedures and advance valuation of artworks for tax purposes. And we have reduced the paperwork burden on taxpayers by issuing a proposed Revenue Procedure on digital computer imaging for storing paper tax documents.

Madame Chairman, we look forward to continuing our work with you and the Members of this Subcommittee on one of my continuing priorities for me -- responsible tax administration while ensuring taxpayers' rights.

IMPROVING COMPLIANCE

Along with responsibility for serving taxpayers and providing easier filing methods; we must also enforce the tax laws — both civil and criminal. In addition to the improvements we have made in serving taxpayers, we are also improving our compliance operations.

Collection

For the three years prior to FY 1994, yield from our Collection operations had declined between 4 and 6 percent, partly because of a decline in productivity. In FY 1994, despite a 9.5 percent decrease in collection staffing, our Collection yield increased 3 percent. In FY 1995, the Collection yield rose by more than 7 percent -- a 10 percent increase since FY 1993.

One way we accomplished this increase was by recognizing that the earlier a debtor receives a request for payment, the greater the likelihood a debt will be paid. We are now requesting payments at the earliest possible time — by the Taxpayer Service function after account questions are resolved over the telephone, or at the close of an audit. In FY 1995, Examination secured payment of 64.2 percent of agreed tax assessments.

We have also expanded the use of an important tool — the installment agreement — to keep taxpayers in the system who cannot immediately pay all they owe. By increasing the installment agreement authority, we raised collections secured this way from \$2.28 billion in FY 1992 to \$5.4 billion in FY 1995.

As part of the effort to increase Collection yield, we are improving our knowledge of the composition of our accounts receivable inventory. When taxpayers either do not file returns or file inaccurate returns, we make assessments based on the tax laws irrespective of collection potential. We record these unpaid assessments as accounts receivable and keep them on our books for as long as they are <u>legally</u> collectible. While we attempt to collect these debts, some accounts are obviously uncollectible for various reasons, for example: the taxpayer has died or is insolvent. In other words, we know at the outset that some of these assessments will not be collected. But our gross accounts receivable does not include just unpaid taxes; it also includes the ever-increasing interest and penalties related to those unpaid taxes. In addition, the law prescribes how long we must keep accounts receivable on the books — 10 years. Thus, unlike private sector businesses, the IRS' accounts receivable cannot be written off even when we know that an account is not collectible.

Having a reliable estimate of delinquent taxes that are truly collectible is essential in enabling us to better manage our collection efforts.\(^1\) At the end of FY 1995, IRS gross accounts receivable inventory equaled \$200 billion of which 28.5% or \$56.9 billion reflected accrued interest and penalties. This is a \$29 billion increase over the FY 1994 balance. A significant portion of this growth was due to additional accruals of interest and penalties, the extension of time we are required to keep the receivables on the books from 6 to 10 years\(^2\), and to our non-filer program. The non-filer initiative was started in 1992 to encourage taxpayers who were not filing returns to get back into the system. While we realized the non-filer program would increase our accounts receivable since many were not filing because of an inability to pay their tax obligations in full, we believed it was more important to get taxpayers filing again and then assist them with ways to meet their obligations by expanding our installment agreement and offer in compromise programs.

The gross accounts receivable inventory for compliance purposes is divided into two components: Currently Not Collectible and Active Accounts Receivable.

- ♦ <u>Currently Not Collectible</u> (CNC) are accounts that a collection employee has determined a taxpayer cannot currently pay. Accounts in this category are periodically monitored, and if a taxpayer is able to pay within the statutory 10-year period, the account will be collected. At the end of FY 1995, \$87.4 billion³ -- or nearly half the gross receivable total -- is classified CNC. Of this amount:
 - 37.6% (\$32.8 billion) is accrued penalties and interest.

 Over 85% (\$75 billion) is not collectible because it is owed by defunct.
 - Over 85% (\$75 billion) is not collectible because it is owed by defunct corporations; taxpayers adjudicated bankrupt; hardships; or the inability to locate the taxpayer.
- Active Accounts Receivable are accounts that are potentially collectible and that continue to be pursued through activities ranging from notices and telephone contacts, to installment agreements and offers-in-compromise, and, ultimately, liens, levies and seizures. At the end of FY 1995, \$88.8 billion⁴ is classified in the Active Accounts Receivable category. Of this amount:
 - 41% (\$36.6 billion) the largest portion of the active account, has been assigned for enforcement action;
 - 22% (\$19.1 billion) of the inventory is either awaiting adjudication by a court or acceptance of an offer-in-compromise;

The GAO has reported and we agree that financial receivables are those that the taxpayer has agreed to or the courts have set, and that from this amount we should estimate a net realizable value of accounts that are potentially collectible. To accomplish this, we have been working with GAO on a better way to represent these amounts on our financial statements. Starting with the FY 1995 statements, we will classify amounts as financial receivables (the amounts that taxpayers have agreed to pay or courts have set), financial write-offs (financial receivables that have subsequently been determined to have no further collection potential), and compliance assessments (those amounts that taxpayers have not agreed to or on which the courts have not acted). These amounts will be audited by GAO.

FY 1995 was the last year in which the accounts receivable inventory would automatically increase because of the extension of time we must keep accounts on the books from 6 to 10 years.

Not included in this balance are Trust Fund Recovery Penalty assessments of \$6.3 billion that are potentially duplicative.

Not included in this balance are Trust Fund Recovery Penalty assessments of \$8.7 billion that are potentially duplicative and Resolution Trust Corporation assessments of \$9.0 billion that have not yet moved to Currently Not Collectible.

- 13% (\$11.7 billion) is currently being collected by sending notices to taxpayers;
- 13% (\$11.2 billion) is being collected through installment agreements;
- 2% (\$1.6 billion) is lower value cases that will be collected through systemic monitoring, such as refund offsets and yearly notices to taxpayers.

Included in these numbers is \$18.5 billion of accrued penalties and interest.

The improvements we have made in the collection process, that I described earlier, not only helped us increase our Collection yield over the last several years but these improvements are also helping us manage the accounts receivable inventory. And we will continue to increase our Collection yield through the use of technology in our field collection operation. In FY 1995, the Integrated Collection System (ICS), which provides on-line access to current account information to our revenue officers, was used in two districts. In these two districts, productivity increased more than 30 percent. This productivity translates directly to additional tax collections "in the bank." In FY 1996, seven additional districts will be using ICS, and it should be fully installed nationwide in FY 1999. Through FY 2004 this initiative alone will result in an additional \$2 billion in revenue collected.

Our FY 1996 appropriation required us to conduct a pilot project to contract out a part of our collection activity. On March 5, we issued the Request for Proposals for the pilot. We intend to award up to five contracts and initially deliver approximately 125,000 cases relating to taxpayers who are delinquent in paying their tax obligations. Payments under the contracts will be performance based; however, they will not be contingency fee contracts. Contractors and their employees will be subject to the disclosure laws, the Privacy Act, the Taxpayer Bill of Rights and applicable sections of the Fair Debt Collection Practices Act. Information provided to contractors by the IRS or collected by contractors from taxpayers cannot be used for any purposes other than fulfillment of the requirements for the awarded contract and cannot be sold or otherwise transferred by the contractor.

Examination

Our compliance program is not only about our collection activities or our traditional efforts to audit taxpayers. We continue to refine our compliance programs by developing new compliance approaches. Through programs like Advanced Issue Resolution and Advance Pricing Agreements, we are stressing early resolution of issues — a practice that saves everyone money. With Advanced Issue Resolution, we can accelerate the collection of the largest corporate assessments by resolving recurring issues and simply carrying the resolution forward to later years. Reducing the number of issues under examination is a cost savings for both taxpayers and for us. Under this procedure, taxpayers have agreed to pay about \$1.1 billion during FY 1993 - FY 1995.

The Advance Pricing Agreement program was developed as a new way to resolve intercompany pricing issues. As a cooperative process, both taxpayers and the government derive significant benefits. Taxpayers welcome certainty in a complex area and avoid a lengthy debate with the IRS. At the end of FY 1995, we had entered into 22 Advance Pricing Agreements, more than the number that had been completed in all the previous years of the program combined. Everything this year points to even higher levels of production, and we currently have 109 Advance Pricing Agreements in process.

We are also responding to taxpayer concerns, for example, those raised by the small business community. I participated in numerous town meetings with small business owners and the White House Conference on Small Business, where small business owners described one of their primary concerns as the worker classification issue -- whether workers should be classified as employees or independent contractors. We are doing what we can to respond to these concerns by revising our training

materials, offering an optional settlement program, and providing early referral of employment tax issues to Appeals.

As I stated earlier, we are finding ways to reduce the amount of paper small business owners have to store, by developing rules that permit taxpayers to use computer imaging systems to replace the paper records now required. We also raised the threshold for meals and entertainment expense documentation from \$25 to \$75, reducing the number of receipts that businesses have to retain for tax purposes.

Working with private industry, we are responding to the increased sophistication of transactions in the financial world and specialization in the business community. We have cooperatively developed Market Segment Specialization Program guidelines, focusing on the practical problems of examining a market segment and identifying particular issues of interest to the IRS. In turn, taxpayers are better informed about the non-compliance in that market and about the IRS's position on that issue. Through January 1996, we had issued 27 Market Segment guidelines covering 23 markets.

Criminal Investigation

In addition to our compliance activities in examination and collection, our Criminal Investigation Division (CI) investigates complex financial transactions of taxpayers, looking for criminal tax violations and money laundering. CI is also actively identifying and investigating new and emerging areas of tax fraud that impact on the economy and prey on honest citizens. These areas include bankruptcy, health care, insurance, motor fuels excise taxes and telemarketing. I would like to share with you the results of our efforts in two of these areas.

Health care fraud is found in a wide range of schemes including home health care, false claims/billings, rolling labs, transportation services, and kickbacks/bribes. While most of this fraud is investigated by the FBI and U.S. Postal Service using the mail fraud statutes, CI investigates them as tax violations if the income is not reported or underreported, the expenses are overstated, or the tax return is otherwise false. CI's ability to bring tax charges coupled with its expertise in money laundering investigations is often essential to the successful prosecution of health care fraud cases. In the last three fiscal years, CI initiated 344 investigations; recommended 168 prosecutions, and obtained 111 convictions in this area.

Health Care Convictions: The CEO of Integrated Systems Incorporated, John P. Milne, was sentenced on October 7, 1995 to 2 years in prison, 5 years' probation and ordered to make restitution of \$1.4 million and pay IRS \$339,780 in back taxes and penalties. Milne plead guilty to charges of tax fraud, making false claims against the U.S., making false statements to banks and mail fraud. His health care scheme involved negotiating reduced medical rates with hospitals, not disclosing the amount of the discounts to his clients and filing for full payment, then keeping the difference for himself. In this multi-agency investigation, CI's financial investigative expertise not only uncovered income tax evasion but also documented a health care scheme which had defrauded numerous health care providers. This evidence provided the proof which enabled the court to demand the \$1.4 million in restitution.

In another Health Care Fraud investigation, Jeanette G. Garrison, owner of Healthmaster Home Health Care in Macon, Georgia, was sentenced on October 30, 1995, to 33 months imprisonment, three years of supervised release and 200 hours of community service on federal charges based on criminal events that transpired while she controlled Healthmaster. She was also ordered to pay \$2.5 million in fines and \$16.5 million in restitution. Garrison plead guilty to one count of conspiracy to defraud the United States and nine counts of false statements. She conspired to defraud the Medicare Program of millions of dollars by the submission of fraudulent cost reports for reimbursement to the Medicare fiscal intermediary between 1989 and 1993. CI special agents, working with the Georgia Bureau of Investigation and the FBI, combed through hundreds of billing records, financial records and invoices to meticulously document and prove this conspiracy against the government.

<u>Telemarketing Convictions</u>. Another growing area of criminal activity is telemarketing fraud. Fraudsters use telephonic and wire communications to fraudulently promote, solicit, or market products and/or services. Monies obtained through telemarketing solicitations are then used to enrich the promoters of these

frauds. Because telemarketing fraud often crosses state borders, federal and state law enforcement agencies must work together to successfully prosecute the cases. From FY 1993 through FY 1995, 133 telemarketing investigations were initiated; 102 prosecutions recommended; and 86 convictions were obtained.

In September 1994, the Western New York Telemarketing Task Force, including agents from CI, uncovered one of the largest telemarketing cases in the Western New York area. Four corporations and 13 individuals were indicted and charged with operating a telemarketing scam that bilked hundreds of victims, mostly senior citizens throughout the United States and Canada; out of millions of dollars. Three of the individuals indicted were charged with Title 26 Section 7211, having to do with making false statements to purchasers relating to tax, a seldom used statute that can effectively be used in telemarketing fraud investigations. This statute makes it a crime for anyone to solicit payment for the sale or lease of an "article" and falsely state, orally or in writing, that any part of the payment, both sale or lease, is to pay federal tax. The Assistant United States Attorney working with the task force has utilized this statute to facilitate plea agreements for individuals cooperating with the government.

REVENUE PROTECTION

The 1995 Filing Season

Last year, I told you, Madame Chairman, and the Members of this Subcommittee that our biggest challenge was to put in place better methods to protect the tax revenue from those who improperly attempted to claim refunds. We accomplished this by use both technology and a different approach to compliance to stop improper refund claims. We used numerous systemic verifications including increased checks of social security numbers. We established new criteria for Electronic Return Originators (EROs), including fingerprint and credit checks, and increased monitoring of EROs. We delayed 7.4 million refunds -- or about 8 percent -- and increased compliance resources devoted to checking these refunds for accuracy.

I am pleased to report that our efforts were successful. One and a half million fewer dependents were claimed, and there were approximately 100,000 fewer earned income tax credit (EITC) claims than in the previous year. CI identified more than 4,100 refund schemes involving almost 60,000 returns, and prevented the issuance of \$78 million in refunds. Last year, we initiated 491 criminal investigations involving refund schemes and return preparers. Prosecution recommendations were forwarded on 404 cases, and we obtained indictments of 329 individuals and convictions in 300 cases. Eighty-two percent of the convictions resulted in prison sentences averaging over 18 months.

Through pre-refund examinations, we prevented the issuance of an additional \$425 million in refunds. We visited over 6,600 ERCs, issued 707 warnings for violations and suspended 287 EROs. Thus, last year, direct compliance efforts prevented \$503 million in improper refunds from being issued. In fact, in its August, 1995 Economic and Budget Outlook update, the Congressional Budget Office decreased anticipated EITC outlays by \$2-\$3 billion a year over seven years, stating, "EITC spending has been lower than expected this year, possibly as a result of a recent crackdown by the IRS"

The 1996 Filing Season

This filing season we are continuing to devote substantial resources to detecting and stopping improper and fraudulent claims for refund. We have refined our efforts to address improper refund claims based on what we learned last year. We are still requiring EROs to meet suitability standards, and we are continuing our ERO monitoring efforts. We also continue to look carefully for suspicious returns and check social security numbers. However, we anticipate far fewer delayed refunds this year as taxpayers now understand the importance of filing returns with correct social security numbers. In fact, so far this year, the number of social security number problems on electronically filed returns have decreased by more than 33 percent from last year.

THE 1995 COMPLIANCE INITIATIVE

⁵ These totals include cases initiated in the prior fiscal year.

In FY 1995, we received the first year of funding for a five-year plan to improve compliance with the dollars raised going directly to deficit reduction. Our FY 1995 compliance accomplishments were impressive. We closed an additional 676,000 examinations and audit coverage increased from 1.08 percent to 1.63 percent in FY 1995. We issued an additional 86,000 determination letters for exempt organizations and employee plans. And, we collected an additional \$803 million directly attributed to the compliance initiative, far exceeding the \$331 million we promised. Overall, with a five year investment of \$2 billion, we had conservatively committed to raise \$9.2 billion in additional revenue. While the loss of the Compliance Initiative impacts federal revenues, an important point that may be overlooked is the corresponding loss in state revenues, because adjustments made during our compliance efforts are used by the states to make corresponding state adjustments without the need for a state audit. MODERNIZING TAX ADMINISTRATION

Modernizing our current tax administration system requires an ongoing effort to update technology, to improve business processes, and to develop a flexible organization. These three items are the essence of modernization, and the IRS is modernizing on all these fronts.

Updating Technology

The IRS has undertaken a series of technology modernization projects -collectively referred to as the Tax Systems Modernization (TSM) Program -- to
modernize its information systems. Originally designed in 1988 as a technology
replacement program, the TSM Program has been redesigned in order to assist the IRS
in realizing its Business Vision in the year 2001, although many of the projects are
scheduled for completion before then and some projects have already been completed.

The TSM Program will enable the IRS to move from paper and more labor intensive processes to an electronic environment, enabling it to more effectively accomplish its mission, which is to collect the proper amount of revenue at the least cost and in a way that imposes the least burden on taxpayers. The TSM Program projects are designed to provide more accurate and timely taxpayer account information to enhance the IRS's customer service and compliance efforts while reducing the number of contacts between taxpayers and the IRS.

Tax administration is dependent on the receipt, analysis and utilization of information submitted by taxpayers and other sources, e.g., employers and other payors. The TSM Program projects fall into three broad categories: those that will facilitate capture of data more effectively and efficiently, those that will improve our ability to store and analyze data, and those that will distribute and use the data to improve compliance and customer service.

All of these TSM Program systems will be supported by a common infrastructure and related support services. Infrastructure components include various telecommunication components, systems administration and operational support systems, security, operating and data base management systems, and an integrated environment for systems testing, configuration control and software distribution. All of the TSM Program systems will be built to assure that confidential taxpayer information will be protected from unauthorized access and use.

Although we recognize that a great deal of work remains to be done in updating our technology, progress has already been made. As I discussed earlier, as a result of technology, taxpayers have more options for filing their returns and paying their taxes than ever before through such programs as TeleFile and Tax Link/EFTPS. Taxpayers are also able to get information from the IRS in many different ways through services like our Internet Home Page and the "fax on demand" service. We also are using technology to answer more of taxpayers' questions the first time they call by providing our employees with access to more account information. Also as I discussed earlier, technology is changing the way our compliance operations work, through such programs as the Integrated Collection System that has improved our collection productivity and the Electronic Fraud Detection System (EFDS), an automated fraud detection system that provides on-line research capabilities which are used to validate

claims and identify multi-return schemes. EFDS was used last filing season and continues to be used to stop improper claims for refund.

We are also putting a new infrastructure in place. A number of initiatives are currently underway with substantial long-term benefits. One of the keys to building a world class information management system is to make appropriate investments in the technical infrastructure -- hardware, software applications and telecommunications. During the past four years, we have awarded contracts that upgrade computer center hardware, modernize operations and allow us to utilize commercial expertise for software and hardware support, information engineering, telecommunications, and security. As of today, \$1.7 billion in new equipment and software has been installed across the country.

Over the past several years, our technology modernization efforts have benefitted from oversight from the General Accounting Office (GAO), the National Research Council (NRC), and the Congress. On balance, we agree with the assessments in the GAO and NRC reports. We take them very seriously, but more importantly, we are doing something about them. The criticisms of our technology modernization efforts can be categorized as follows:

- Accountability and Management the need to centralize management of technology modernization in one office;
- Managing Information Technology Investments the need to better prioritize technology investments;
- Software Development the need to develop procedures that ensure the development of high quality software;
- 4.) Technical Infrastructure the need to develop a comprehensive blue print of the infrastructure:
- Electronic Filing the need to develop a comprehensive strategy for electronic filing.

During the past year, management of the TSM Program has changed significantly. Modernization management has been centralized under the Associate Commissioner for Modernization, who has been given the responsibility and authority to manage and control consistently all systems development and reengineering efforts within the IRS. In September 1995, the Associate Commissioner for Modernization became responsible for the formulation, allocation, and management of all information systems resources. This was an important step in the process of ensuring that all information systems resources are used in accordance with the IRS's strategic objectives.

The Modernization Management Partnership (MMP), a management structure which includes me and the Assistant Secretary for Management/Chief Financial Officer as well as other senior IRS and Treasury Department officials, was established last year to identify and address important technology modernization issues at the Departmental level. The Deputy Secretary has taken action to strengthen the MMP so that it will function more like a board of directors, with day-to-day responsibility for the TSM Program remaining with the IRS.

In response to criticisms about the lack of a clear plan for implementing the TSM program and an adequate analytical process for establishing investment priorities, we put in place an investment review discipline to select, control, and evaluate investment decisions based on GAO best practices. An integral part of this discipline is the Investment Review Board, established in October 1995, chaired by the Associate Commissioner for Modernization, which is responsible for assessing and prioritizing information systems investments, monitoring progress of spending against plans and evaluating the results of those investments. In addition, we recently reexamined our entire modernization program to ensure that information technology investments produce the maximum business value. Based on the results of this review, we are

establishing achievable and manageable priorities for the next five years. We also have a new Chief Information Officer (CIO), Mr. Arthur Gross, who will work with the Associate Commissioner for Modernization. He plans to begin work on April 15th. Mr. Gross was previously the Deputy Tax Commissioner responsible for systems and processing for New York. In that position, he led a broad tax modernization effort for the state during the past several years.

We recognize that our software development capabilities as well as those of our contractors must be improved, and we have taken positive steps in that direction. Our contractors are required to perform at a level that produces high quality software. We are also improving our own systems development capabilities to ensure that the TSM Program is developed consistent with modern processes and standards. Specifically, we are enhancing our system architecture and test plans to provide the critical road maps for developing and implementing fully integrated systems.

A vital aspect of updating our technology is enhancing our capabilities for safeguarding taxpayer information. IRS concurs with NRC's advice regarding the security of tax processing systems and the privacy of tax information. Information systems security and integrity has been and will continue to be one of the highest priorities for the Internal Revenue Service. I have issued two policy statements - the Declaration of Privacy Principles in 1994 and the IRS Information Security Policy in 1995. Based on a similar recommendation from GAO, we recently completed a Security Concepts of Operation which provides an IRS users' view of the security capabilities in the TSM Program systems which will protect taxpayer data from unauthorized access or disclosure. Security will also be an integral part of the information systems architecture.

We are also relying heavily on private sector expertise to assist in our technology modernization projects. To meet the significant challenges of such a large-scale effort, we have the ability to access private sector skills and experience through contracts with the IRS' Federally Funded Research and Development Center (FFRDC), the Integration Support Contract (ISC) and the Treasury Information Processing Support Services (TIPSS) procurement.

We have developed a plan with the help of outside experts from other governmental agencies and the private sector to aggressively expand the work of the current Integration Support Contractor. Under this new approach, the Integration Support Contractor will assume as much of the systems integration role as the existing contract permits. This will include the architecture, systems engineering, integration and test activities that are essential to successfully integrate the systems. IRS will continue to make the decision on final design and development. Production software development work is and will be contracted out.

in addition, the newly-instituted Presidential Technology Team will bring experienced technical professionals from across government to work on technology modernization. The IRS, in fact, worked with OMB to create this concept and will be the first beneficiary of its effort.

We are working to increase electronic filing options — like TeleFile — and payment options — like TaxLink/EFTPS. To accomplish this, we are developing a comprehensive strategy for electronic filing. We are also taking a hard look at how we currently receive returns from taxpayers, and studying ways to reengineer the entire process.

Improving Business Processes

Along with updating our technology, we are also improving our business processes to make them more efficient and effective. For instance, in 1994, the IRS volunteered to serve as a pilot agency for the Government Performance and Results Act (GPRA). GPRA requires agencies to set goals, establish measures, and report on their accomplishments, as well as integrate performance measures into the budget and strategic planning process. Our participation as a GPRA pilot agency has helped us improve our budget, strategic planning and evaluation processes. This year as part of our GPRA responsibilities, we are integrating our planning, budgeting and assessment processes and will complete the first draft of an Integrated Strategic Plan and Budget next month.

We have also reengineered many of our administrative processes to be less labor intensive and to take advantage of available technology. Through an innovation we call "Employee Express," our employees can now manage their own employment accounts, directly changing their tax withholding, savings bond allotments, Thrift Savings Plan contributions and other personnel actions through the use of a touch tone telephone or centrally located kiosks. In the past, these employees filled out forms and sent them to their personnel offices where other employees made the changes to the payroll system.

We have also fully automated our travel accounting system, and this system was showcased as an example of a government agency implementing the best practices of the private sector at a March 8 hearing on Government-Wide Travel Management before the Senate Committee on Governmental Affairs, Subcommittee on Oversight of Government Management and the District of Columbia. In reengineering this process, we were able to eliminate all but two steps: a certification of the claim by the traveler and the approval by the supervisor. Employees are reimbursed in about five to seven days. In FY 1995, we processed 83 percent of our travel vouchers or about 325,000 vouchers electronically.

We have also changed our business processes so that we can serve taxpayers better. For example, as I stated earlier, we have eliminated certain notices we send to taxpayers, and we are in the process of reviewing the remaining notices to make them more understandable. We are providing information to taxpayers in new ways, for instance through our Internet Home Page. Also, as I discussed earlier, in our compliance efforts, we are rethinking the way we accomplish our mission and putting more emphasis on working with taxpayers on difficult issues with such tools as alternate dispute resolution and Market Segment guidance. We will continue reviewing our processes and make changes that will make us more efficient and make it easier for taxpayers to deal with us.

Business Structure

The remaining part of our modernization efforts involves realigning our organizational structure to make it more efficient and effective. We are concentrating on the work currently performed by Service Centers, Computing Centers, Automated Collection and Taxpayer Service telephone sites, and district offices. During FY 1994 and 1995, we consolidated our 70 phone and correspondence operations into 34 and will consolidate ultimately in 23 Customer Service Centers. We will soon be operating with three Computing Centers responsible for centralized mainframe computing instead of the twelve operating today.

On October 1, 1995, the number of regions was reduced from seven to four, the staff in the remaining four regions was reduced, and we began to consolidate from 63 district headquarters to 33 offices. The district consolidations are ahead of schedule and will be completed by October 1. In the summer of 1993, we decreased the number of locations providing administrative support services from more than 80 to 24; three more will be eliminated this year. Despite this 38 percent decrease in support services managers and an overall decrease of 20 percent of support services employees, the job is getting done.

FY 1997 BUDGET REQUEST -- FY 1996 BUDGET

I would like to discuss briefly the IRS's FY 1996 Budget and our FY 1997 Budget request. I have included as an Appendix a summary of the FY 1997 request. As you know, the IRS submitted a budget request for FY 1996 of \$8.2 billion, and received an appropriation of \$7.348 billion, less than the IRS's \$7.483 billion FY 1995 appropriation. This decrease posed a particular challenge to us since we require about \$200 million more each year for cost increases beyond our control, such as pay raises and rent increases, just to maintain our current level of operations. Our FY 1996 budget allows us to run our basic operations and will not affect the processing of returns or the payment of refunds within our customer service standards of 40 days for paper filing and 21 days for electronic filing during the 1996 filing season.

What we will not be able to accomplish again are the impressive results we achieved in deficit reduction last year through our Compliance Initiative funding. Based

on our current FY 1996 funding, we will not be able to perform some 290,000 examinations, with a potential loss in revenue collection of \$324.8 million. Examinations through our information reporting program will also be affected. For example, reductions in our document matching program and our substitute for return program, an effective means of addressing non-filing, could result in a potential loss of \$417 million in collected revenue.

Madame Chairman, in your invitation letter you asked us to try to anticipate the effect on IRS operations if the President and Congress approve an FY 1997 appropriation level which is no greater than the FY 1996 level. Flat funding really means a \$200 to \$400 million reduction from our FY 1996 funding level because we must absorb pay raises and increased costs. As a result, we would be faced with difficult choices.

Like this year, we will make it a priority to sustain our basic operations — processing more than 200 million tax returns and paying more than 90 million refunds. To accomplish this, however, we will, like we did this year, have to find alternate ways to serve taxpayers, and, like this year, we will have to decrease the amount of face to face contact with taxpayers. The number of audits will decrease, with a corresponding decrease in the audit coverage rate, and some of our collection operations may have to be curtailed. While we will continue to process tax returns and pay refunds on time, service to taxpayers may suffer and the amount of money collected next year could be impacted. But what is more difficult to measure is the longer term impact of reductions on overall taxpayer compliance levels.

CONCLUSION

Since becoming Commissioner almost three years ago, I have worked hard to improve our service. I am pleased to report progress. Despite that progress, we recognize that we still have much to do.

FY 1997 BUDGET IN BRIEF

Internal Revenue Service



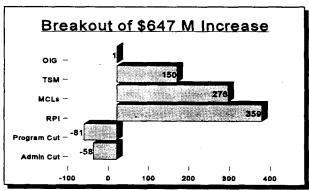
I. Introduction-A Three-Part Investment in Tax Administration

or FY 1997, the Internal Revenue Service has proposed a series of investments that will substantially reduce the burden on the American taxpayer, enhance compliance, and maximize revenue collections. The Service is submitting budget proposals for FY 1997 that total \$7.995 Billion and 109,050 FTE. The total budget request represents an increase of \$647 Million and 2,699 FTE over the FY 1996 operating level. Our FY 1997 budget consists of three equally significant and critical investment components:

- A. The Tax Systems Modernization (TSM) Program. IRS is in the financial services business. The Service performs the same basic functions—collecting money, processing data, maintaining customer accounts, and responding to customer questions. Its 200 million customers expect it to do these activities accurately and efficiently, while maintaining the highest level of integrity and safeguarding their privacy. The TSM Program projects are designed to provide customers with better, faster service as well as enhance compliance. IRS has requested \$150 Million in additional TSM Program funding in FY 1997 for four tax systems modernization investments. These investments will finance immediate and tangible improvements in our service to taxpayers, with emphasis on electronic receipt of tax returns and payments, extensive data capture, streamlined storage and retrieval of data, and early identification of issues with as many as possible resolved with a single telephone call. In response to guidance received from Congress, the National Research Council and GAO, the Service will extensively use contractor support in developing and integrating modernized operational systems.
- B. Revenue Protection Initiative. The Service is requesting \$359 Million and 3,820 FTE for a Revenue Protection Initiative (RPI) that is estimated to generate \$1.5 Billion in FY 1997—a return on investment of better than 4 to 1. During the outyears—FY 1999 and beyond, the increase to enforcement revenues from this investment will exceed \$3 Billion annually. All staffing increases will be placed in call sites and service center based enforcement programs. Not only do these telephone and correspondence activities represent highly cost effective investments that emphasize up-front treatments and early contacts with taxpayers, they are also less intrusive and burdensome than traditional face-to-face enforcement actions that rely on revenue agent and revenue officer involvement. In reviewing the proposed FY 1997 initiative, Congress should consider the proven record of delivering the revenue promised in connection

with the FY 1995 Compliance Initiative. In FY 1995, the IRS received the first year of funding for what had been a five year plan to improve compliance with the dollars collected going directly to deficit reduction. The FY 1995 accomplishments were impressive. Over \$800 Million was collected, far exceeding the \$331 Million promised. While the loss of the Compliance Initiative impacts federal revenues, an important point that may be overlooked is the loss in state revenues, because adjustments made during IRS compliance efforts are used by the states to make corresponding state adjustments without the need for a state audit.

C. Maintaining Current Levels of Service. The Service needs \$276 Million just to maintain its FY 1996 program levels in FY 1997. These additional resources, which are offset by administrative and program reductions totaling \$139 Million, are needed to cover the expected increase in the number of returns filed. The resources also are used to pay for unavoidable staffing related expenses, such as pay increases. Finally, the additional resources are needed for inflationary increases to non-staffing related expenses, including postage, printing, and essential contracts, such as those for National Archives and Records Administration and Financial Management Services. These costs represent bills the IRS does not control, but must pay. Without these resources, the Service will be forced to reduce programs, or to shortchange funds intended for training, supplies, enforcement travel and essential enforcement expenses.



Total Decreases: \$139 Million

Total Increases: \$786 Million

Note: A detailed breakout of increases and decreases is contained in Appendix A-Budget Overview.

II. Mission and Objectives-Collecting Revenue to Finance the Government

he mission of the Internal Revenue Service is to collect the proper amount of tax revenue at the least cost; serve the public by continually improving the quality of our products and services; and perform in a manner warranting the highest degree of public confidence in our integrity, efficiency and fairness. To achieve its mission, the Service has identified three strategic objectives.

- A. Increase Voluntary Compliance. IRS encourages and assists taxpayers to file timely and accurate returns and pay on time. When taxpayers do not comply, appropriate enforcement action needs to be taken.
- B. Maximize Customer Satisfaction and Reduce Burden. The Service works to reduce the time and expense to taxpayers, tax professionals, and others in complying with the tax laws, while increasing their satisfaction with the tax system.
- C. Achieve Quality-driven Productivity through Systems Improvements and Employee Development. IRS is using systems improvement tools and techniques to develop a highly-trained work force.

III. Performance Measures Hierarchy - Results-Based Budgeting

s. one of the country's largest financial services organizations, the IRS needs to be a leader in managing its own finances. The IRS volunteered to serve as a pilot for the Government Performance and Results Act (GPRA), which requires agencies to: formulate strategic plans that articulate their mission, goals, and objectives; develop annual performance plans that spell out annual targets against the strategic goals; measure program performance against their strategic goals and objectives; and hold themselves accountable for achieving results.

As part of its GPRA responsibilities, and to integrate its planning, budgeting and assessment processes, IRS has developed a hierarchy of performance measures. At the top of this hierarchy of measures is a barometer of overall Service performance. This indicator compares the amount of revenue collected during a fiscal year, minus the IRS costs of collecting that revenue and minus the monetized value of the burden hours placed on taxpayers in meeting their tax obligations, with the amount of revenue that would have been collected if all taxpayers had paid their full tax liability.

The second level of the measures hierarchy contains measures for the Service's three strategic objectives. Also at this level are measures that require the interrelated efforts of multiple functions. The mission and objective level measures and performance targets for FY 1997 are shown in the following table. The multi-functional measures can be found in Appendix B-Performance Measures Hierarchy.

Finally, the third level of the measures hierarchy contains the measures for the Service's 18 budget activities. These 18 activities represent the Service's various functional components, each activity contributes toward the achievement of the Service's mission and objectives. Details on these measures are also shown in Appendix B--Performance Measures Hierarchy.

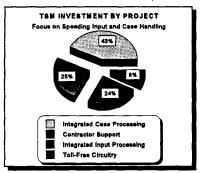
IRS PERFORMANCE MEASURESMI	ISSION AN	п овјес	TIVES
Performance Measures:	FY 95	FY 96	FY 97
Mission. Collect the proper amount of tax	evenue al l	he east co	
Revenue Collected - (Budget+Burden) Total True Tax Liability	.7766	.7825	.7887
Objective: Increase Compliance, rockie			
Total Collection Percentage (TCP)	86.0%	86.3%	86.7%
Total Net Revenue Collected	\$1.271T	\$1,358T	\$1.450T
Objective: Maximize Customer Satisfaction	and Reduc	e Berdes,	
Revenue Collected per Dollar of Burden	\$10.97	\$11.38	\$11.80
The time expended by taxpayers in fulfilling their tax responsibilities (Hours)	5.3 B	5.3 B	5.3 B
Favorability of IRS (Roper Survey)	36.0%	47.0%	49.0%
Objective: Achieve Quality-Driven Product	vity. 15 ans		
Revenue Collected per Dollar of IRS Budget	\$172	\$185	\$181

IV. The Tax Systems Modernization Program

he Service is requesting \$150 Million for a series of Tax Systems Modernization Program investments. These investments will finance immediate and tangible improvements in IRS' service to taxpayers. The additional resources will be used for the following projects:

A. Integrated Case Processing System/Integrated Collection System. With the resources provided by this initiative, IRS employees will be provided with greater access to information and the ability to resolve issues over the telephone by installing 3,500 Integrated Case Processing workstations, 22% of the total workstations required. The Service will also

automate many of the activities of field revenue officers, by implementing the Integrated



Collection System in 20 of 33 districts, providing access to 60% of revenue officers. Finally, IRS will modernize telecommunications infrastructure and data and voice connectivity by funding 14 additional sites for universal wiring, approximately 15% of the total universal wiring requirements.

Chart breaks out \$150 M TSM Proposed Increase.

B. Contractor Support. With the resources provided by this initiative, we will provide funding for contractor support in developing and integrating modernized operational systems, in response to guidance received from Congress, the National Research Council and GAO. The Service will use its major integrator to perform the necessary architecture, systems engineering and design tasks so that specification of hardware, software, and telecommunications products will lead to a fully functioning system. The integrator also will play a major role in the design and development of the

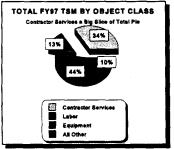


Chart breaks out total \$850 M TSM Request.

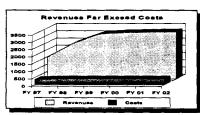
Workload Management System, which will provide the IRS with a corporate system to track and prioritize workload.

C. Integrated Input Processing System. With the resources provided by this initiative, the universe of taxpayers that can file electronically by telephone will be expanded through funding toll free circuitry costs associated with expanding Telefile.

D. Toll Free Circuitry. With the resources provided by this initiative, the Service will resolve many more taxpayer inquiries through a combination of increased on-line assistance and self service applications, using Voice Response Units, which permit callers to route themselves to interactive systems or to specially trained IRS assistors.

V. Revenue Protection Initiative-A Modest Investment with a Big Return

the Revenue Protection Initiative (RPI) is a continuation of the Service's long term strategy to improve voluntary compliance. Consistent with the Service's business vision, the emphasis is on resolving issues by telephone and avoiding more costly face to face contacts with taxpayers. The return on investment is significant—4 to 1 in FY 1997 and 7 to 1 from FY 1997 to FY 2002.



Total Revenues: \$16B

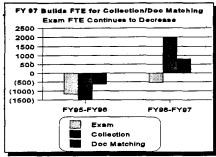
Total Costs: \$2.4B

The remaining one-third of the total program is for three programs. First, Document Matching increases will finance enhancements to the Underreporter Program, which compares data from information returns with filed returns, and also to the Substitute For Return Program, which creates returns for taxpayers who fail to file returns. Second, Examination increases will fund more correspondence audits by service center employees, which will increase the audit coverage rate from 1.4% to 1.5% while expanding revenues.

RPI involves four major programs. Collection represents about two thirds of the total program increase. Staffing for Automated Collection System call site and Service Center Collection Branch programs will generate more than \$1.25 Billion in revenue in FY 1997. Beyond these increases, the Collection component includes 240 FTE for the Individual Tax Identification Numbering System (ITIN). Scheduled for implementation in the Philadelphia Service Center in July, 1996, ITIN will—during its first year in operation—generate valid TINs for over one million taxpayers (mostly non-resident aliens) who do not have social security numbers.

FY 97 I	REVENUE	INITIAT	TVE
Program	FTE	\$(000)	Revenue
Collection	2,490	\$263	\$1,265
Exam-SC	300	\$ 35	\$88
CI(QRDT)	230	\$2 1	
Doc Match	800	\$ 40	\$136
TOTAL	3,820	\$359	\$1,489

FY 97 Benefit Cost Ratio is 4 to 1.



Includes Base and Increases, Exam excludes Appeals

be used for Questionable Refund Detection Teams (QRDT), aimed at protecting revenues by prosecuting individuals involved in large scale fraud schemes.

Third, the Criminal Investigation increase will

As shown in the chart on the left, the Service's revenue producing activities were reduced in FY 1996. This initiative would restore the reductions to Collection and Document Matching and in the process bring in additional resources and reduce the Federal deficit. The total resources for Examination,

which absorbed a big share of the program reduction discussed below, would continue to decrease. The impact of total FY 1997 staffing on some key performance measures is shown at the right:

KEY PERFORMA	NCE MEAS	SURES
Measure:	FY 96	FY 97
CollectionYield	\$24.9 B	\$25.9B
UR Assessments	\$1,368M	\$1,619M
SFR Assessments	\$1,292M	\$1,140M
Audit Recommended \$	\$23.8B	\$23.4B
Audit Coverage	1.54%	1.51%

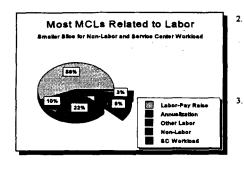
UR=Underreporter SFR=Substitute For Return

VI. Maintaining Current Levels of Service

o maintain current operations and protect the integrity of the filing season, the Service must have the resources to pay for both the inflationary costs associated with statutory pay and other mandatory increases in support costs, and the expected increases in the number of returns filed.

A. Mandatory and inflationary Costs Related to IRS Staff:

 Pay Raise and Benefit Increases. The statutory pay increase for FY 1997 is expected to be 3.1%. Total cost is \$155 Million. Without this increase the Service would be forced to reduce FTE and disrupt program delivery.



- Annualization This increase is needed to annualize the FY 96 pay increase. Total cost is \$28 Million. Without this increase the Service would be forced to reduce FTE and disrupt program delivery.
 - Non-Pay Raise Labor Increases. IRS has experienced \$61 Million in labor cost growth in excess of that budgeted for in the usual pay raise and personnel benefit inflation. This is because promotion costs result from

career ladder advancements, above journey level promotions, and within grade increases. Without senior graded employees, the Service would be hampered in working higher graded cases in Examination, Collection and other budget activities. Absent this increase the Service would be forced to reduce FTE and programs.

B. Service Center Workload Growth. Resources will cover the projected increase in Service Center workload (processing tax returns and issuing refunds) which is due to growth in the taxpayer population and tax law changes. Primary tax returns are expected to reach 199.5 million in FY 1997, an increase of 2.4 million from the current year estimate of 197.1 million. Supplemental documents (amended returns, extensions to file, etc.) are projected to increase. 5 million from the FY 1996 level of 12.1 million.

VII. Program Decreases

here are two categories of decreases. First, there is a program reduction that represents the Service's portion of a base program cut applied to most Departmental bureaus to help balance the Federal budget over the next seven years. Second, there is the fourth year's installment of administrative cost reductions mandated by Executive Order.

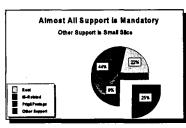
A. Program Reduction. Because a base reduction cannot be achieved through further administrative savings, the cut is being taken as a program reduction that could have some impact on the Service's ability to collect revenue in FY 1997. This reduction is being taken in the more traditional enforcement job categories—those that engage in face-to-face examination and collection activities. While these positions continue to be vital to the overall enforcement efforts, and will always play a major role in collecting revenue, the IRS business vision calls for shifting the balance of the enforcement programs toward those that are featured in the Revenue

Protection Initiative (RPI), discussed above. RPI consists of programs based in the service centers and call sites that deal with taxpayers by telephone and through correspondence. Without RPI, the FY 1997 program reduction to traditional "back-end" enforcement functions performed by Revenue Agents and Revenue Officers is not offset with increases to new "front-end" enforcement functions.

B. Administrative Reduction Pursuant to Executive Order. This reduction reflects the FY 1997 adjustment relating to Executive Order 12837, which requires agencies to

JOB CATEGORY FTE R	EDUCTIONS
Revenue Agents	462
Revenue Officers	230
Special Agents	88
Tax Auditors	91
Tech/Prof/Clerical	470
TOTAL	1,341

reduce administrative costs by not less than 14 percent from FY 1994 and FY 1997. This is to be achieved by annual reductions of three percent (five percent in 1997) to the baseline FY



Other Support pays for training, case travel, enforcement expenses, etc.

1994 amount, adjusted for inflation. These reductions have exhausted the Service's ability to make support reductions. Although IRS has a support budget of \$2 Billion, over three fourths of it is either information systems related, and used to purchase ADP equipment or telecommunications, or is mandatory, and pays for categories such as rent, postage, and printing. The remaining one fourth, has been reduced severely, what is left is used for case related travel; enforcement expenses, including lien

fees; training; and services and supplies, such as computer discs.

VIII. Conclusion



he FY 1997 dollars invested in IRS will be well spent. The Service has proven that it can deliver on its promises. Our investment request is not large when compared with the potential benefits--both in additional revenue collections and in improved service to

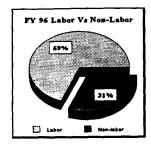
taxpayers.

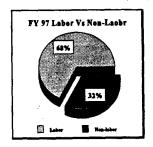
Appendices:

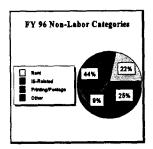
- A. Budget Overview
- B. Performance Measures Hierarchy

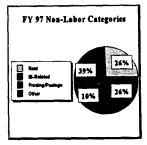
Appendix A

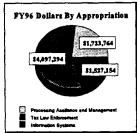
BUDGET OVERVIEW











\$1,779,663 \$4,527,821 \$1,687,674 \$1,087,674

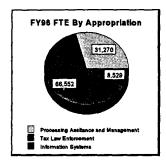
FY97 Dellars By Appropriation

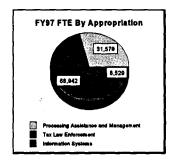
Dollars in Thousands

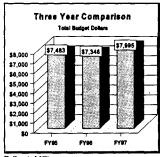
Dollars in Thousands

Appendix A

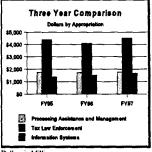
BUDGET OVERVIEW







Dollars in Millions



Dollars in Millions

Budget Overview

\$1.248.218	
E 804	
ECENT	
KOPERATII	

FY 1997 CHANGES:		
. Maintaining Current Operations	FTE	000/\$
a) Maintaining Current Operations		
1. Labor	ı	5.90
2. Non-Labor	ı	24,575
b) Arrusization of FY 1996 Pay Raise	;	28.10
c) Service Center Workload Growth	22	7.22.7
- 5	,	61,000
Subtobal	82	275,812
2. Reductions	FIE	2000
a) Admin. Cost Reduction (E.O. #1283	1	(58,200
b) Compliance/S Program Reduction	341	(80,500
Subtotal	113411	(138,700

E	(58,200
2	80.50
11	9,700
=	9
-	64,176
	38,024
	36,000
	900
16	000'0

4. Revenue Protection Initiative	319	\$(000)
CI (QRDT)	230	20,812
Exemination - Service Center	8	36,423
Collection - ACS & SCCB	2,280	250,746
Document Matching	8	39,631
<u> </u>	240	12,385
Subtotal	3,820	358,997
5. Other	FTE	\$(000)
OIG Rembursement	ı	834

	he pay raise in the most		
	ociated with		Per selector
	ary costs ass ts a GSA anti		population. riority and hi
	ncreased sal		in texpayer
	rent reduction	By 1389.	to the growd resulting in
	uded is a 3%	r FY 1996 p	athition rate
rations	nt operations es. Also snot	997 to pary fr	er the project part to lower
Current Ope	sintain curre	tory eded in FY 1	needed to cor rowth due in
1. Maintaining Current Operations	 (a) In order to maintain current operations, the Service must fund, increased safary costs associated with the pay raise and inflationary price increases. Also syckuded is a 3% rest reduction that reflects a GSA admate based on the most 	recent site inventory. (b) Amounts needed in FY 1997 to pay for FY 1996 pay raise.	(c) Resources needed to cover the projected fromese to the growth in taxpayer population. (d) Labor cost growth due in part to lower attrition rates resulting in increased servicrity and higher sellaries.
-	3	ě	99

Amounts needed in FY 1997 to pay for FY 1996 pay make. Resources needed to cover the goving the project decrease in the growth in tappayer population. Labor control growth due in part to lower attributes instea resulting in increased seriority and higher sealeries.

2. Reductions (a) The FV 1937 adjustment responding to Encodine Order 17837, requires togencies to reduce administrative costs by not less than 14% between 1948 and 1987, the FV 1987 reduction is 5%. (b) The Service's portion of a base program cut applied to all Departmental bureaus - includes a \$67.5 million cut to TLE lend a \$13 million cut to 15.

S. Tax Systems Moderntization.

This system is increased by the control of the co

il Revenue Protection Initiative

Revenue Protection Initiative (191) is a continuation of the Service's long-term strategy to inprove voluntary considered. Protection Initiative (1919) is a continuation of the Service's long-term than the initiative can be expected to generate more than 15 to failtren in additional revenue. See FY 1997 revenues are expected to total \$1.5 claim (1919 saffing increases are mainty insigned at call the area of the service control charged enforcement tograms. These activities represent highly confidence investments and see less influence and becomes than traditional lines to those information additional activities and buckenome than traditional lines to those information additional.

6. Other Resource requirements for IRS in FY 1997 include a program increase for the cost of the IRS portion of an sudded Francial statement in order to meet requirements of the Covernmental Management Reform Act of 1994 (P.L. 103-355).

Appendix B

		FV 1996 Actual	Fy 1996 Estimate	FY 1987 Extimate
Mazion Measure Collect the proper smount of tax revenue at the least cost.	Revenue Collected - (Budget + Burden) Total Total Total Lability	0.7786	97,00	0.7887
Objective Measures Increase Voluntary Compliance	(1) Total Collection Percentage (TCP)	86.88	26.3%	2
	(2) Total Net Revenue Collected	\$1.271 T	\$1.358.T	\$1.480 T
Maximize Customer Satisfaction	(1) Revenue Collected per Dollar of Burden	_	\$11,38	\$11.86
	(2) The time expended by laxpayens in fulfilling their tax responsibilities	5.3 Billion Hrs	6.3 Settlon Hrs	6.3 Billion Hrs
		4		5
Achieve Quality-Driven Productivity	(1) Revenue Collected per Doller of IRS Budget	2112	\$185	1918
Multi-functional Measures				
	COLD MAYORINE PTOMICIOS	97%	200	4
	Increase in Net Revenue Collected	9985	8787	82.05
	2		1	1
	Distinct Offices	42.6	9	203
		74.44	200	2007
	PRP Quality Customer Service Rate (CSR)			
		74%	78%	78%
	Service Centers	8	É	*02
kidget Activity Measures - Submission Processing	Member of orbital returns filed (in thousands)	183.150	197.063	199.615
Burgara Landers	Number of supplemental documents fled (in thousands)	11.937	12.127	12.580
	Total number of Individual refunds issued (in thousands)	88,736	90,510	94,684
	Processing accuracy rate - paper	2.5	838	***
	Propessing accuracy rate E.L.	8		
	Keturd Impeness – paper (gaye)	8	3 2	3 4
	% Dollar emount of Federal Tax Deposits received electronically	126	18.4%	*
	% Refums filed on media other paper	38	*6	**
	% required individual refurms filed	¥98	¥98	£ 24
	And the state of t		į	art cas
- Taxpeyer Services	MUTTOR Of CARS STREAM - 108-1106 (INCROMING) 1 09-10X CARS)	016	700	107./1
	TPS annual accument	25.0	×10	316
	TPS Lavel of Access(Sevicewide meeture)	38.6%	41.4%	423
	Calls assessed as N. of school-de	311	\$8	X80
	Initial Contact Resolution (ICR) rate formerly called One-Stop Contact Rate)	75.5	*	Ě
	Tarqueyer Contacts/FTE	7,069	6,843	6,843
	Attended to the second flood for second to the second second to the second seco	=	9	410
- mapacron	recovered to recent recovered to the second	1	3	8
	Number of security investigations conducted	9.350	9.456	8.479
	Amount of fines, restitutions, and funds recovered or imposed by judicial order (in thousands)	\$5,682	\$6,348	26.364
	Number of prosecutions/Administrative actions	0.00	1,00	8
Management Condition	% of Produces Trained in Sedema Menagement	8.79%	\$0.8	\$1.6
	Training Fife % of Total Fife . RA	*06	809	53
	Training FTEs % of Total FTEs - TA	19.0%	80.6	3.0%
	% Bargaloing Unit Employees Piting Step 2 Orlavances	¥.	ž	ž
	Absentee Rate	宝	67 Hrs	# Hrs.
	TOP CASE PERSON	748	100%	1

Financial Investigation		8	108	764
	National Convictions			908
		355	1	
	TAXANCE INTO A CONTROL OF THE PROPERTY OF THE	*	2	Š
	Publicized investigations per FTE	9.0	0.7	0,7
	Fraudulers return deletion rate - paper and electronic	10%	×2	¥98
	Refund fraud deterion rate - paper and electronic	78%	*28	*88
· Examination	Examination Measures			!
	recommended accepture fax and petamen	979 979	973.00	\$23.45
	Audit coverage	*S	× ×	1.61%
	Cycle Time (Days) RA 1040 Business	\$	28	582
	Cycle Time (Days) RA 1040 Nonbusiness	327	317	700
	Cycle Time (Days) RA 1120	375	38	363
	Ovete Time (Days) TA 1040 Business	285	757	672
	Cocts Time Cheek TA 1040 Nordensigneds	215	508	203
	CEP Curency (Open Year Average)	32	32	3.1
	S/Four Mean RA 1040	7987	100	\$1.038
	School Meen RA 1120	\$1,073	\$1.16	\$1,140
	Satura Mean TA 1040	1183	\$650	\$1.00
	M-hour caring Total Adjusted Revenue (TAR)	1 S. B.	15,727	\$6,900
	% of Acres of and Partially Acres of CEP Examinations	1.5%	78.5%	79.6%
	V. Assessed & Codected Before 2nd Notice	27.73	65.6%	×6 05
	Accessed Management			
	Work Units Closed, Non-Dockesed	42,513	41,622	43,183
	Work Units Closed, Docketed	22.813	22.436	23,277
	Revenue in Billions of Dollars, Non-Doctreted	2.078	2,017	2,924
	Revenue in Billions of Dollers, Docketed	0.616	0.003	0.826
	Agreed Cesen, Non-Docketed	35.371	24,830	36,928
	Agreed Cases, Docketed	20,586	20.169	20,926
	Legae Days, Non-Docksted Under 310 million	243	236	228
	Lapsa Days, Non-Dockstad \$10 million and Over	824	2	18
	Increase % of Appeals Officer direct time	66.8%	46.8W	\$40 BB
- Chief Counsel	Technical Advice and Service Assistance (Completions)	288	4,566	4,588
	Private Letter Rulings and Advance Pricing Agreements (Completions)	3,256	3,960	3,040
	Regulations, Revenue Rutings, and Revenue Procedures (Completions)	ē	2/4	674
	Docked Tax Utgation Case Courtes	28.787	26,180	26,180
	Dockeled Tax Litigation Dollers Protected for Closures (\$000s)	\$2,087,331	\$1,943,290	\$1,943,290
	Dodewied Tax Libgation Cycle Time	ž	530	ŝ
	Counsel Bankrupkcy - Closures	\$30,515	78,484	28,684
	Countied Bankrupkcy - Dollers Protected (\$000s)	\$6,631,466	16 233,600	76,213,60d
	Coursel Lifegation Support — Criminal Tax Closures	5,617	6,280	9,280
	Coursel Lifegation Support – General Legal Services Closures	3,247	3,062	3,962
	Coursel Litgadon Support - Other General Litgation Closures	\$6.03	2	45.288
	Counsel Litigation Support - Refund Closures	7	2	8
	Coursed Litigation Support - Refund Dollars Protected (1000s)	\$72,528	\$66,176	\$48,175
		9	ş	
Course Organizations	C. Creminatori Cont. Time (Cont.)	3	702	753
transfer officers	EV CAMPETINISTEEL STATE (LATE)	24.800	20000	20,000
	TO CONTRACT THE RESERVE THE PARTY OF THE PAR		-	
· International	Foreign Controlled Corporation Direct Exam FTE	23	5	=
	US initiated Competent Authority Case Cycle Time (Days)	35	8	730
	Foreign Indiated Competent Authority Case Cycle Time (Cays)	287	8	200
	kritemational Enforcement No Change Rate (Days)	22.48%	21.4%	20.4%

Appendix B

	Collection Tield	23.18	\$24.9	25.90
	ACS Average Cycles to Dispose TDA/TDI	23.9	239	752
	CFf Average Cycles to Dispose TDA/TDI	28	42.1	41.6
	ACS Level of Service	28%	*68	85%
	ACS Average Hours per Entity Disposition	3.5	3.7	3.6
	CFI Average Hours per Entity Disposition	44	49.8	48.8
	ACS \$ Callected FTE	\$1,124,000	\$1,236,000	\$1,060,000
	CFI \$ Collected FTE	\$413,000	\$438,000	\$480,000
- Document Matching	Assessments, Undergooder (Millions)	83 658	£1 368.1	£1 £10 A
	Assessments, Substitute for Return (Millions)	\$1.948	\$12017	\$1,140.0
	Refunds, Underreporter	\$120	28	\$128
	Information Returns Received (Millions)	1,052.0	1.154.4	1.139.6
	% of Information Documents Processed	%89.96	%B9.96	\$6.00%
- Resources Management	Support Services Timeliness Index	100.0	100.0	100.0
Compliance	Support Services Cycle Time Index	100	105.4	105.4
	Support Services Cost Index	000	103.6	103.8
	Support Services Customer Satisfaction Index	1000	1000	100.0
	Support Services Quality Index	1000	1000	100.0
- TSM Modernized	FY 1997 Modernization Scheduled Program Accomplishments			
Operation of strains	FY 1997 MODERNIZATION SCHEDULE	1		
:	# The performen researce for the requested investment in tax systems moderations will be provided as part of the report inquested in the 1996 appropriations of the floate and Senate containing, among four specific requests, a site of research is not implementation of all projects included in the tax systems modernization program.	part of the report requ I Senate containing, a ization program.	ested in the 1996 mang four specific	approprietions requests, a

Chairman JOHNSON. Thank you, Commissioner. I appreciate your testimony. And for the Members' knowledge, included in your testimony is quite a long section on debt collection, and you may get a chance to address that in the course of the questions.

Before we get into that, however, let me turn to some other matters, just to return to the part of your testimony where you discussed the impact of your screens last year and your efforts to reduce fraud, particularly in the EITC Program. The outcome was very impressive. Are those screens working this year? Do you have reason to believe that you are going to be able to maintain the progress you made last year? Do you think there will be any increased benefit from the work that you have done to reduce fraud in that area?

Ms. RICHARDSON. Very much so, Madam Chairman. We installed our electronic fraud detection system and a number of filters this year based on things we learned last year. We feel that we certainly weren't going to lessen our efforts, but we were able to refine what we were doing, which I think accounts for the fact that, as you pointed out earlier, we are having a much smoother filing season. But we have certainly not lessened our commitment to preventing refund fraud.

Chairman JOHNSON. There are some other areas where you have a lot of concern about fraud, one of which is health care fraud.

Ms. RICHARDSON. Right.

Chairman JOHNSON. Could you discuss your efforts in that area? And are there any new things in this filing season that you are doing to try to identify fraud? As a Member of the Health Subcommittee of this Committee, we are keenly aware of the problems in some of the provider service areas.

Ms. RICHARDSON. Well, as you and I have discussed, health care fraud is an area that is of grave concern to us and to other Federal law enforcement agencies, as well as State law enforcement agencies. And it is an area of growing concern. It is not particularly geared to a filing season, so we don't have anything that we do that is unique to the filing season. However, our Criminal Investigation Division is working closely with other law enforcement agencies in a number of major health care fraud investigations. We reported on a couple of convictions in our written testimony. I would be happy to provide you and the Committee more information about it.

[The following was subsequently received:]

Many fraud experts estimate that at least 10 percent of all funds expended on health care is lost to fraud. This would mean that over \$100 billion is lost annually to fraud.

IRS' current criminal investigations reflect that the scope of health care fraud is extraordinary, not only in the financial losses incurred, but also in the malicious intent of the perpetrators who prey on the most vulnerable members of our society.

IRS currently has 183 health care fraud cases under criminal investigation. The number of cases under investigation has increased from 76 in FY 1993 to 183 currently. The current inventory of cases consists of the "classic" types of health care fraud schemes involving fraudulent claims made by physicians, clinics, and others involved with the health care industry. In addition, they also encompass a broader range of related industries, such as ambulance and patient transportation services, which are not commonly thought to be a part of the health care industry. Since health care fraud is a multi-faceted problem that is pervasive throughout the industry, we anticipate an even greater commitment of IRS' criminal resources in the future.

The cornerstone to combating health care fraud is cooperation between federal law enforcement agencies and industry. Cooperative efforts magnify the results which could be achieved through individual agency efforts and represent the most effective use of IRS' scarce resources. The cooperative efforts currently underway are best exemplified by the Health Care Fraud Task Forces mandated by the Attorney General. These task forces have been established in every judicial district under the leadership of the respective United States Attorney. IRS agents are members of these task forces where their unique skills are in demand in the investigation and prosecution of these complex financial crimes.

The diversity of health care cases under investigation by the IRS are illustrated by the following examples:

- On February 28, 1996, a former dentist was sentenced to two years in prison for defrauding the Medicaid Program and income tax evasion. To generate fraudulent Medicaid billings, the dentist extracted, filled, and installed crowns on healthy teeth of poor children. This scheme began in 1985 and continued until 1992. IRS' investigation established that in tax years 1987-1989, the defendant failed to report over \$219,000 in income annually.
- Taxicab Scheme On October 20, 1995, forty-two individuals were
 indicted with cheating the Medicaid system out of at least \$4 million
 by falsifying transportation costs. The investigation substantiated
 several types of fraud including submitting claims for services not
 performed and over billing Medicaid for services when actually
 provided. Defendants face prison terms ranging from one to thirty
 years and fines from \$100,000 to \$250,000.
- <u>Pharmacist</u> On October 12, 1995, George A. DiLeo, a former pharmacist, entered into a plea agreement with federal prosecutors by admitting he defrauded \$350,000 from state and federal government insurance programs and failed to report \$274,000 in income to the IRS. DiLeo was sentenced to 8 months in a halfway house, 3 years probation, and 200 hours community service.

Chairman JOHNSON. Are you making any changes in your screens or enforcement or forms or routine business in order to reduce the possibility of fraud in this area?

Ms. RICHARDSON. I might have Jim Donelson comment.

Mr. Donelson. Madam Chair, if I may, on the compliance side, the criminal investigation organization has open cases in the health care industry. We know that there is approximately \$100 billion annually that experts estimate is lost through fraud in the health care industry, and we are concerned about that money flowing through that industry and the potential of money laundering and other aspects of, as you describe it, fraud in that industry. So we do have cases throughout the country that have been initiated by our criminal investigators.

Chairman Johnson. The \$100 billion is the industry activity. That is not—

Mr. DONELSON. Exactly. It is not the tax implication.

Chairman JOHNSON. In terms of the reduction in your budget last year, and particularly looking to the future, some of the things you are doing like encouraging filing by telephone, making your forms available, some of the projects you have done to make it easier to pay your taxes and easier to get the information you need to do so have also reduced some of the burden on your staff.

Ms. RICHARDSON. That is correct.

Chairman JOHNSON. In looking at absorbing reductions, has there been any reduction in taxpayer services?

Ms. RICHARDSON. Well, we have certainly had to reduce the face-to-face contact, as I mentioned in my oral statement. But we have tried to provide alternatives for taxpayers to get information through our automated telephone system, our TeleTax system. We have had, I think, about 28 million calls this year that we have already answered through our TeleTax system. It is a system where you can get refund information, the status of your refund, and there are automated answers to 148 of the most frequently asked questions.

As I mentioned, we have our forms and publications on the Internet. We have a fax-on-demand system for forms as well. And we have almost 20,000 volunteer tax counseling for the elderly sites this year. So we have done what we could to try to serve more customers, but not necessarily do it in a face-to-face way.

Chairman JOHNSON. From the comments that I get from my constituents, my conclusion is that you have successfully improved your ability to service taxpayers in a number of automated ways and that you actually do have the personnel to satisfy the walk-in business and the face-to-face contact that is necessary. Would that be your conclusion?

Ms. RICHARDSON. Well, obviously we would always like to be able to serve more people and answer more phone calls.

Chairman JOHNSON. I understand.

Ms. RICHARDSON. I think anybody in business, and particularly in the customer service business, would like to answer every call on the first ring. But we understand that resources are somewhat limited.

Chairman JOHNSON. What is the primary focus of your professional education and training efforts? And to what extent are they going to be affected by tight budgets?

Ms. RICHARDSON. I might ask Jim Donelson to address that. He is both Chief, Taxpayer Service and Acting Chief Compliance Offi-

cer and knows a lot about the professional education issues.

Chairman Johnson. And as you are talking about that, would you talk about if there are impacts on your training programs, which ones. And are you doing it equally across the board, or are there programs that you are committed to retaining at the same level or stronger? I want to get a better idea of the training component, how it affects staff capability, and how reductions in funding are being handled.

Ms. RICHARDSON. Excuse me. I might just say in a general way, though, what we have tried to do in the last several years and will continue to do is analyze our training money so that we can provide the highest quality training with the least amount of cost. We are doing much more with distance learning, using videos, videoconferencing, and teleconferencing. A good bit of our training money in the past had gone to pay for travel and lodging as people came for offsite training. We are trying to shift that balance so that we can provide high-quality training to a greater number of people.

Mr. Donelson. Madam Chairman, if I may, we have had to take some reduction and cuts in our continuing professional education and training, as well as our outservice training where we send our employees out to receive training outside the Agency. We are continuing to give the basic training to our employees and making the cuts as judiciously as possible where we think we can afford to take them. I am sure that there are employees that wish they could have certain training courses that we just can't afford to send them to as we may have in the past, and we have done a lot, as the Commissioner has said, by using technology to train people across the country.

Our Office of Chief Counsel has a very excellent process that they use for satellite training around the country, and we are engaging in that to help train our examination people, for example. And we continue to run our CID, our criminal investigation people, through the Glynnco Program, as well as all of the other Treasury enforcement agencies. So we have taken cuts. We have tried to absorb them as judiciously as possible.

Chairman JOHNSON. Thank you very much. I am going to recognize my colleague, Congressman Laughlin, for some questions, and then we will come back to the TSM issue. Thank you.

Mr. LAUGHLIN. Thank you, Madam Chairman.

Commissioner Richardson, one of the most serious criticisms that has been leveled at the Tax Systems Modernization Program is that there is a lack of focus and an inability to establish priorities. Both the General Accounting Office and the National Research Council have raised this repeatedly in their reports.

Have you prioritized your systems development efforts? And can you provide us with a list of programs where you will focus your

resources?

Ms. RICHARDSON. Yes, Mr. Laughlin, and as I mentioned in my oral statement, we have taken those criticisms very seriously, and

I think they are valid criticisms. I would like to get Mr. Dolan to tell you what efforts we have had underway this past year to

refocus the program and reprioritize the various projects.

Mr. Dolan. One of the things we did, Mr. Laughlin, is we looked at—as this endeavor started, as the Commissioner said in her testimony, back in the late eighties, it was, I think, designed originally more as a replacement of technology, and what we have done very aggressively in the last several months is put the cart maybe a little bit back behind the horse in the sense of looking at some of our very basic business choices and looking at the parts of our business for which we most wanted to leverage the technology.

We went through last summer something we called a rescoping effort which essentially had us take all of our projects and priorities and apply them against a metric that the General Accounting Office had advanced to us as a best practices set of metrics. We evaluated our investments both in terms of their business value to us and their risk on a cost and schedule basis. And we essentially have redone our entire suite of investments in what we now think is a much tighter focused set of increments that both are high value on the side of achievability and high value with respect to the benefit they bring to the customer and customer service, to compliance, and then to us in terms of productivity.

Mr. LAUGHLIN. Well, could you give us the list of the programs

where you are now going to focus as a result of these efforts?

Ms. RICHARDSON. I would be happy to submit these to you for the record. We have four reports that we are in the process of finalizing for the Appropriations Subcommittee, and one of those reports will have that list in it. We would be happy to provide that to you as well

Mr. LAUGHLIN. Provide it to the Chairwoman, if you would. [The following was subsequently received:]

Paper Filing	Process Remaining Paper More Efficiently	Document Processing System (DPS) Service Center Recognition/Image Processing System (SCRIPS) Lockbox	Modernization Foundation	Robust Infrastructure	Servicewide Technical Infrastructure (STI) Software Development Environment (SDE) Enterprise Security System (ESS) Customer Support and Automated Operations (CSAO) Revenue General Ledger System (RGLS) Telecommunications	Сотріїапсе	Give Employees Access to Complete Information and Modern Tools	Integrated Collection System (ICS) Compliance Research Information System (CRIS) Compliance Data Warehouse (CDW) Examination Support Electronic Fraud Detection System (EFDS)
Electronic Filing	Provide Alternative Means of Filing and Paying	Electronic Federal Tax Payment System (EFTPS) Electronic Management System (EMS) CyberFile TeleFile Simplified Tax and Wage Reporting System (STAWRS)	Modernizati	Bulld and Maintain a Robust Infrastructure	Workload Management System (WMS) Corporate Accounts Processing System (CAPS) Sevice Center Replacement System (SCRS) Consolidation Corporate Systems Modernization/Mirror Image Acquisition (CSM/MIA)	Customer Service	Give Employees Access to Complete Information and Modern Tools	Customer Service/Integrated Case Processing Automated Self-Service Applications Toll-Free Operations

Table 3-1. TSM Projects by Program Components

Mr. LAUGHLIN. In the past there have been serious questions with respect to your ability to leverage the resources provided by outside contractors. Can you tell us how you plan to improve the use of the outside resources?

Ms. RICHARDSON. Particularly in respect to the Tax Systems Modernization Project?

Mr. LAUGHLIN. Yes.

Ms. RICHARDSON. As I mentioned in my opening statement, we have a systems integrator, and we are moving to utilize them to the fullest extent possible under the contract. Most of the software development on the big projects that we have underway or will undertake will be done by outside contractors. We are working with our systems integrator to make sure that all of the projects integrate as they come together in the final analysis.

Mr. LAUGHLIN. In that area, our staff has given us some information, and I have got to tell you, I share their concern that there appears to be high tech, high cost, but low performance. This brings to mind the debacle at the Denver airport in their baggage-handling system. And in my earlier life in Congress, I was on the Aviation Subcommittee, and we heard too much about what was

going wrong there.

Can you tell us what is happening from your management viewpoint that will alleviate the concern that we have that we are going

to have a Denver airport baggage problem here?

Ms. RICHARDSON. Well, as I mentioned in my opening statement—and I think we went into more detail in the written statement—we have taken to heart the criticisms. We have put in place a different management structure than we had in the past. All of the authority for modernization—the budget, the resources, and reengineering efforts, not just the technology piece but the reengineering of our business processes—is currently the responsibility of the Associate Commissioner for Modernization. We have a new Chief Information Officer who will be joining us in 2 weeks who has had extensive experience in technology modernization in a major tax administration system.

Mr. Dolan mentioned we moved to reprioritize. We had a project last fall where we reprioritized our investments. We have set up an investment review board so that each and every project has to be rigorously scrubbed for its business investment potential to aid us in our business. A very strict business case, using some of the GAO best practices that we worked with them on, has to be made

in order for a project to be funded.

We also recognize that many of the projects that people would like to have had or would like to have done are no longer affordable. The unlimited budgets that looked like people were going to have in the late eighties and maybe early nineties are not going to be there, so we are trying to focus our attention on the projects that we think are most important for us to provide good customer service and also to enhance compliance. Other projects will not be funded unless they meet these rigorous criteria.

Mr. LAUGHLIN. In your review, have you identified programs that are no longer needed because of changes in technology, because of new programs? And are you in the process of identifying any that

are required by law that are no longer needed? And I think on that last point, you and I had this discussion yesterday.

Ms. RICHARDSON. Right.

Mr. LAUGHLIN. If so, what can we do to eliminate those that are no longer needed because of changes that you have either implemented through technological advances or new programs?

Ms. RICHARDSON. As I mentioned to you yesterday, we will give some thought to those on the question that they may not be needed

because of changes in the law and I will get back to you.

Mr. LAUGHLIN. And that will include elimination of some programs that we may not need anymore because of either new programs or new innovations that the Service has implemented.

Ms. RICHARDSON. Right.

Mr. LAUGHLIN. You have also spent a great deal of time on developing a business plan for tax system modernization. I understand you are working on a plan to make sure that you develop integrated systems to implement the business plan. When do we get to the implementation itself? Do you have the contractors you need to do the development work?

Ms. RICHARDSON. Again, the reports that will be coming out within the next 30 days should hopefully address the overall plan, the blueprints, and I believe we have most of the contracts in place that we feel we need in order to accomplish our objectives under that business plan. I would ask the Associate Commissioner, Judy

Van Alfen, if she would like to elaborate on that.

Ms. Van Alfen. Yes, we do have contracts in place that will help us deliver our goals. As both the Commissioner and the Deputy have mentioned, we have been very much involved in looking at all of our investments and laying them out on a 5-year plan, and also breaking them down in a 2-year rollout. We have also strengthened our processes so that we can do a better evaluation of those investments as we move forward.

The contract that we have in place will assist us greatly in moving out of the integrator role which we have chosen to take in the

past and moving our integration contractor into that rule.

Ms. RICHARDSON. One project I might mention, Mr. Laughlin, is our integrated collection system which is being used by collection officers. It was used last year in two districts and is being rolled out to more districts this year. But in the two districts where it was fully operational last year, productivity actually increased by

over 30 percent, which translates into money in the bank.

Mr. Laughlin. The Federal Government has been pursuing for some time a long-term exercise to reduce the size of the Federal work force, yet the 1997 fiscal year IRS budget proposal proposes to increase the work force at the Internal Revenue Service by 2,699 employees. Why should the IRS be exempt from the downsizing that is occurring throughout the Federal Government? And, second, what effect has the reduced 1996 appropriation had on IRS personnel? Does the Service expect any furlough days or any reduction in force?

Ms. RICHARDSON. Mr. Laughlin, I think in fiscal year 1991 we had about 119,000 FTEs in our budget. This year in fiscal year 1996 we have 106,000 FTEs. So we have certainly not been exempt from any reductions in the Federal work force.

We are 8,000 FTE below where we were 1 year ago. Most of that money and most of those people are directly involved in either frontline collection activities, frontline compliance activities, or in processing tax returns and making sure that money is timely deposited in the Federal Treasury and making sure that people are paying their proper share of taxes, as Chairman Johnson mentioned in her opening statement. Many taxpayers are concerned that while they are paying their proper share, others are not. They want to be assured that others are paying their share of taxes.

At the same time, we don't feel we should be exempt from scrutiny about how we spend our money and whether we use it wisely. And I have said on every occasion meeting with employees, that we, too, need to enhance our productivity and find new solutions to old problems. But I think that the increases that are being proposed for next year are largely in the compliance area and will

largely go to raise money that will go for deficit reduction.

Mr. Laughlin. Madam Chairman, I will yield back. Thank you. Chairman Johnson. Thank you. To that last general point, I think some of the projects the IRS has taken on are impressive and have been very successful. The telefiling seems to be going very well. It is clearly improving the quality of taxpayer service and will relieve your staff, and the broader that initiative becomes—now it is very limited to a small group of taxpayers—the more important a resource it will be for taxpayers and the IRS and the more it will enable us to reduce the number of employees in an intelligent and responsive fashion.

There are others of the Tax Systems Modernization Projects that have been very fruitful for us, so for that reason, because I know some of the projects have been very successful, I do want to put on the record and ask you to talk a little bit about the truly shock-

ing depth of criticism of the Tax Modernization Project.

The GAO said there is little tangible evidence that actions being taken will correct the pervasive management and technical weaknesses that continue to plague TSM. GAO described the IRS' software development capability as unlikely to build TSM in a timely and economic manner, and the systems are unlikely to perform as intended. The IRS has placed its software development capability at the lowest level, described as ad hoc and sometimes chaotic, and indicating significant weaknesses.

Now, even for GAO, that is pretty strong criticism, and GAO has worked with you over all the years that you have implemented this system. So words of that nature are very concerning to this Over-

sight Committee.

In addition, the National Research Council just last month reported that the IRS has had serious technical capability problems that cast doubt on the overall success of TSM if they are not solved. If the IRS does not begin to improve its development processes—and you have spoken here to some of those efforts that you have made to improve your development processes. But they say if you don't take strong corrective action, TSM will degenerate into a collection of individual projects that are poorly integrated, with inadequate privacy and security safeguards that may or may not be able to cope with the increased workload.

Now, these are very strong statements, very recent statements, followed by Deputy Secretary of the Treasury Larry Summers' testimony before the Treasury and Postal Appropriations Committee that TSM has gone badly off track and it needs to be rethought from bottom to top.

Now, you are familiar with all those statements, but the depth of their criticism is very concerning to me, and when they talked specifically about the Integrated Case Processing Project, a \$64 million project in 1997, their conclusion was that frontline employees had not had enough input in its development to assure its usefulness to end users.

Now, you are making some changes. They are at the top. The problem doesn't entirely seem to be at the top. There seems to be a systemic issue here that if it is not addressed, it almost doesn't matter how much money you put into technology if it isn't going to be integrated and if the frontline people haven't been part of generating the solutions.

Now, I say this as one who represents a manufacturing district, machine tools, bearings, those kinds of industries that suffered extraordinary challenge at the hands of targeted and grossly unfair foreign competition. But as they tried to survive, they rethought from the bottom. And when they first tried, they rethought from the top and they failed. And not until they rethought from the bot-

tom did they succeed.

The level of criticism that is coming from the National Research Council recently and from the GAO I hear in the light of my experience as the consequence of the old bureaucratic tendency to solve from the top. And that isn't just a public sector problem. That is a private sector problem. Authority tends to believe it can find solutions, and what I want to know is: What is the problem? When you look back at what you have been through—because you got a lot of good people, and you have really worked hard on this. And you have in certain pockets. I mean, I have known this, but I saw it with you in my own office recently. You have made some very significant improvements in your equipment, in your capability, and are able to serve taxpayers at certain levels and in certain instances very much better. On the other hand, you still can't adjust a change in address or if a taxpayer gets married.

The cases that tend to come to the Members' offices are those kinds of cases: For 3 years now we have been dunned because they can't get through their system that we are now married and we

have one name and not two.

So the profound level of criticism that you are receiving is of great concern to me, and having been involved in it in good faith and having accomplished some measurable achievements, to what do you attribute this criticism? And what are you going to do to address it, aside from putting new people in the boxes? Because we had new people actually in the boxes a few years ago.

Ms. RICHARDSON. Well, in fairness, the boxes have changed. We did have a Chief Information Officer, but we did not have an Associate Commissioner for Modernization. And one of the early criticisms I think of both the General Accounting Office and certainly the National Research Council was that we needed a single point of accountability for all of modernization and that accountability

had to be not just for the technology piece of it but for the business side of it as well.

As I mentioned, that position was actually created last year. Judy began in October after her predecessor retired. I think that having that single point of accountability has made a significant difference because it has allowed her and her staff to really take charge of all of the resources for technology, not just what would fall under the Tax Systems Modernization Program.

Chairman JOHNSON. Not by way of criticism, but just by way of information, was there not a single point of accountability sooner because you really thought communication would do it? Or what prevented that from happening sooner? Was it lack of real understanding of the sort of vertically integrated process that has to

make change?

I do appreciate that you have done that now. I don't understand why that didn't happen sooner, why it wasn't clear to the Agency that more authority had to be invested in the person or in the

group that was going to lead this.

Ms. RICHARDSON. I can't speak to this situation prior to my time. I think that one of the issues and one we touched on earlier—and it is not, I think, unique either to the Federal Government or to the private sector—is that the project began as an upgrade of technology without a lot of thought given to changing business processes. And I think it was in part viewed within the province of the Information Systems Division and the Chief Information Officer. People on the business side, compliance, taxpayer service, and other parts of the organization, were interested in modernizing technology, but I don't know that they were integrated into what was happening with the technology modernization that was being led by the Chief Information Officer's efforts.

Chairman JOHNSON. OK. Let's get that a little clearer because that makes a lot of sense to me. What I hear you saying is that

it started out as a technology project. Ms. RICHARDSON. Yes, ma'am.

Chairman JOHNSON. But it became a review of how the whole

agency does its business.

Ms. RICHARDSON. That is correct. The technology modernization began—or thinking for it began certainly in the late eighties, but I think in response to both criticisms from the General Accounting Office as well as the National Research Council, the organization realized that it needed to really rethink its business processes and then be able to leverage technology. You didn't just automate old ways of doing business. That caused a real change in approach, change in thinking, and change in the way we began to look at the whole process of modernization.

Chairman JOHNSON. And in addition to appointing a single point of accountability, what changes are you going to make to ensure that there is much deeper involvement from the Agency itself? Because it is a fairly recent comment that was made that the ICP is going to have problems and is not ready to go operational because there wasn't enough frontline employee involvement in its develop-

ment.

Ms. RICHARDSON. I might let Mr. Donelson take a crack at some of this, but he and I were both out at our Fresno Service Center

last week—I think it was last week or the week before—looking at where we are basically prototyping our customer service and the use of ICP. We very much have taken into account what frontline employees think, want, and need in trying to make ICP accessible to the people who will actually have to use the system, not just the people who were designing the system or who were developing the software.

We have two prototypes—one in Nashville, which is a district office, and one in Fresno, which is a service center. We have moved ahead with the prototype in order for our frontline employees who are using the systems to obtain experience and help in the development process so that we can make a system that works for the ultimate customer, that is, the frontline employee, as opposed to someone sitting back in Washington or sitting back in a design studio.

Chairman JOHNSON. What specific role did those employees have

in the process of change?

Mr. DONELSON. The employees have input into the various changes that are made as we try to improve the product. We have had a version we call 1.5 that has been operating in Fresno, and suggestions from employees as to how that should be enhanced—

Chairman JOHNSON. And is the suggestion process informal or

formal?

Mr. DONELSON. It is formal. And they——Chairman JOHNSON. What form does it take?

Mr. DONELSON. Well, we have working groups that have been at this for some time who are a mixture of higher level managers as well as employees, union representatives as well as managers.

Chairman JOHNSON. When you hear that kind of criticism of your ICP, your Integrated Case Processing Project, does it concern you?

Mr. DONELSON. I will answer that. Absolutely. But one of the reasons the Commissioner and I——

Chairman JOHNSON. Because the feedback from outside experts indicates that the IRS may be trying to go operational with ICP too quickly, which could be a mistake. For example, there is concern that frontline employees have not had enough input in its development in order to assure its usefulness to end users. This is a big issue because if this project doesn't reflect the level of horizontal involvement in planning and doesn't come out with a technology that really is powerful to the people in the frontline in their daily lives, then other projects will be seen as in jeopardy.

Mr. Donelson. Madam Chairman, the Commissioner and I were out in Fresno just 2 weeks ago because of that kind of criticism that we have heard, and we both went out to see it live, and the demonstration that we saw was presented by a union official, as a matter of fact, an employee who represents his fellow employees. And I can only describe his enthusiasm as overwhelming. He walked us through the system, showed us all the terrific aspects of it from his vantage point, how it makes his job not only easier but more fulfilling because he gets to solve taxpayers' problems with one call. He was extremely enthusiastic about it, and he said it was very easy to learn. He said he learned it in just 4 hours of kind of working with the system and teaching himself, as well as the instruction that he was given. So I think that that was an indi-

cation to me that the needs of our employees will be met by this system.

Ms. RICHARDSON. I think that they also had a very formal role in designing the workstations, designing the functionality, as the word seems to be, and to make it suitable for our frontline assistors.

Mr. DOLAN. Madam Chairman, if you would permit, you ticked off a string of criticisms that both thread themselves through the GAO and the NRC and the last part of it we have been talking about is the ICP. One of the difficult things in a hearing like this is to sort of say two things. One is that the essence of the criticism is an essence that we agree with, and at the same time get a chance to talk about how, when all those words and all those criticisms and all those things aggregate in reports that build on each other, sometimes reporting essentially the same thing and other reports that look like there are now five reports that say the same thing, and also dealing with language like "little evidence that actions will"—well, part of our frustration is we are in the midst of reacting about as aggressively as we know how to a body of work that we actually asked get done and that culminated in a briefing last April, a formal report last July, as a template for how, if we were to do all that we could do, how we could really ratchet ourselves from this series of places where we didn't have our act as well together as it might be, into this admittedly world class undertaking. And I think what I would like to hope is that as we deliver against this middle of April date to the appropriators, what will be resident in the four sets of reports that basically our appropriators asked us to come back with is not anything that would allow anybody to say "little evidence," but hopefully something that would say a heck of a lot of evidence.

Now, some of that evidence will be evidence of work in progress, because one of the other things you talked about was our software maturity level. If you read that report on its face, someone might infer that we should take an organization that is today, by metrics that the Carnegie-Mellon folks use, a level 1 organization, and because we are resolved to improve it, should in 3 or 4 or 6 months make that a level 2 organization. It doesn't happen that way. Experts inside and outside will tell us that it doesn't happen that way. They will tell us that as an organization trying to do what we are doing, we had better have level 2 or better skills available to us, and so we have made a very conscious decision that some part of our inside cadre must get to level 2, but we have also made a conscious decision an awful lot of that software is going to be written on the outside, and it is going to be written by people who are already level 2 or above. Our integration support contractor is a level 3 organization.

So what on the face of it is criticism that we say is right on, you can't do this world class endeavor if you are operating at level 1, but when we get a chance to work behind some of those recommendations and talk about, first, what we are doing, and, second, what we will do more of, I would like to believe we could satisfy you that we are not standing still but, quite the contrary, aggressively moving to deal with the essence of those. And your ICP example is another one. That report upon which that data is drawn

is based on observations that at this point have to be, conservatively stated, 18 months old. We are in a pilot which is the way we chose to make sure that the front-end involvements around this get done correctly before we roll it to the entire organization.

A series of iterations have done exactly what you have suggested is the right thing to do, which is to get the iterations of the people using the systems to come back and make a version 1.0 grow to a version 1.5, grow to a version 2.0, all before that gets then visited on the organization as an operational system to roll out across the board.

So the criticism on the front end of if you don't do it this way it will be a failure, is accurate criticism, but the dipstick was taken 18 months ago and I think today we could lay out a series of things we have done which are, indeed are, the positive kind of reactions from that observation.

Chairman Johnson. Well, I do believe that you as an agency have achieved some real improvements in recent years, and out there on the frontline you are doing a better job in many regards, and I think the EITC fraud effort that you made last year was a very successful one. And while it involved some delay—and this is sort of off the subject of tax systems modernization, but there are many areas in which you actually have pressed hard and have some significant success to show for it. I thought your collection figures were very impressive.

As I listen to what you are saying and put together the information that you have given me and that we have talked about over the last year, I am pleased to see the aggressive actions that you are taking to deal with the top-level issues and the architectural issues in a sense, the biggest and most difficult issues that everything else has to fit into. And I think probably the best thing for us to think in terms of is an oversight hearing in about 6 months on how far have you gotten, what did this mean. Because we don't have the same timeframe anymore that we had when this project started 5 or 6 years ago. So there does have to be some real payoff to hiring some of these people. You are more knowledgeable below that person and to work with that person, and so at that time we certainly want to get a better view of how the architectural issues are moving and also of frontline involvement amongst employees.

Thank you for your comments on those issues.

Mr. Laughlin.

Mr. LAUGHLIN. Thank you, Madam Chairman.

Commissioner Richardson, I have a couple more questions on your testimony today and I want to ask the question of you in conjunction with some statements that Chairman Jim Lightfoot of Iowa said about the Modernization Program being a \$4 billion fiasco. In your testimony you talk about, "As of today, \$1.7 billion in new equipment and software has been installed across the country." Somewhere in here, my information is it is about \$3.5 billion, and Chairman Lightfoot has a \$4 billion price tag.

Ms. RICHARDSON. He rounded it up, he told me.

Mr. LAUGHLIN. OK. Let's just use the \$3.5 billion. But when we use your figure of \$1.7 billion for equipment, it seems a staggering amount of money left over for overhead and salaries and consultant

studies, and I just want to ask you: Is all of the almost \$2 billion

going for salaries and overhead?

Ms. RICHARDSON. We would be happy to supply you with even more detailed figures for the record. I believe that \$3.5 billion has been appropriated to date, and of that amount, \$2.7 billion has been spent. And when I say appropriated to date, I mean through this fiscal year.

[The following was subsequently received:]

The amount obligated on TSM through the end of FY 1995 was \$2.77 billion, with \$84 million of the funds appropriated between FY 1988 -1995 available for expenditure during FY 1996. Below are the amounts expended (and obligated) through FY 1995.

Amounts Expended through FY 95 (Dollars In Millions)

Category	Dollars
Salaries/Benefits (FTE)	\$647
Computer Hardware/Operations	\$623
Software, Commercial Off the Shelf (COTS)	\$76
Service Contracts	\$560*
Telecommunications	\$331
Site Preparation Costs	\$279
Support, Training and Travel	\$262

^{*}Includes contracts for Engineering/Integration, Strategic Planning/IV&V, and Software Development.

In addition, TSM was appropriated \$695 million in FY 1996, of which \$265 million has been committed/obligated to date. An additional \$317 million has been distributed to the Financial Plan and is being committed, \$100 million is fenced pending submission of the report to Congress on the Status of IRS' Management and Implementation of Tax Systems Modernization by the Secretary of Treasury. The balance of \$13 million will be distributed within the next few weeks based on Investment Review Board (IRB) priorities. Below is a delineation of the total amounts obligated through March 22, 1996.

FY 1996 Obligations To Date (as of 3/22/96)
(Dollars In Millions)

Category	Dollars \$48 (payroll data thru 2/96)	
Salaries/Benefits		
Equipment	\$53	
Services	\$157	
Supplies	\$3	
Support	\$4	

Mr. Laughlin. Let me tell you why I am asking this question. I saw in the newspaper today where the Postal Service is using not tax money but revenue money from postage and the Postal Service talking about funding both political conventions. And I am not suggesting that the IRS is doing—

Ms. RICHARDSON. We are not going to do that, I promise you.

Mr. LAUGHLIN. I think that is an absolute misuse of postal revenues to fund political conventions or the World Series or the Rose Bowl or the Cotton Bowl, if it is ever played again in Texas. But

the concern I have is: Where is this money going?

Then I read a report today that some of the labor unions have outfitted a brandnew jet, or the head of some union, I am hopeful that we will get a report that all of this is going to modernization of equipment and not recarpeting of the Victoria, Texas, IRS office, which happens to be down the hall from my office.

Ms. RICHARDSON. Right.

Mr. LAUGHLIN. I don't suspect that is happening, or my staff would have told me.

Ms. RICHARDSON. No, I can assure you—

Mr. LAUGHLIN. Do you see where I am headed? I think this Committee is entitled to know where is this \$2 billion going.

Ms. RICHARDSON. Absolutely. And I would be happy to provide you great detail for the record. But I might ask Judy Van Alfen to

give you some sense of it.

Ms. VAN ALFEN. Yes, we have been appropriated \$3.54 billion. We have spent \$2.77 billion, and we have in our budget for this year \$695 million. We have spent money on telecommunications, including expansion of telecommunications so that we could deliver our integrated case projects and our ADP acquisitions and operations costs, off-the-shelf software. It pays for contractor costs for development of software, engineering and integration, strategic planning and support by our contractors. It also pays for site preparation to be able to install our initiatives. It does cover IRS salaries, travel, and training in connection with the various projects, and we have some other supports costs. We will be happy to give you further breakdowns on that.

Mr. LAUGHLIN. Fine. And, Commissioner, again your written testimony says, "We have developed a plan with the help of outside experts from other governmental agencies and the private sector to aggressively expand the work of the current Integration Support Contractor. Under this new approach, the Integration Support Contractor will assume as much of the systems integration role as the

existing contract permits."

I want to key in on "existing contract permits," because my question to you is: Why not modify the contract to make the contractor a real integrator by making him the prime contractor? It is my understanding that the outside contractors can't implement anything without IRS permission. And it seems to me you don't get good input or innovation if the den mother has to approve everything. It occurs to me that we ought to have more flexibility and consider modifying the contract.

Ms. RICHARDSON. As I understand it—and I am certainly not a contract lawyer, and I would be happy to provide you with some people who can give you much more detail, we cannot unilaterally

modify the contract that we have with either our systems integrator, or any other, and turn them into a prime contractor. In order to do something like that, there are a number of legal requirements that would have to be met, and we are not in a position to do that without some significant changes, I think either approval of Congress or rebidding of the contracts. But it is not something that can be done unilaterally or even bilaterally with the one contractor.

Mr. LAUGHLIN. Sure. I would just ask you to review that area, and it doesn't have to be made a part of the record, but I certainly would ask you to make some type of response or report to Chairwoman Johnson—

Ms. RICHARDSON. One of our four reports to Congress that will be coming out in the next 30 days will discuss the role of the integrator and what we are doing to try to get ourselves out of being the integrator.

Mr. LAUGHLIN. And I would like in that report for you to address to the Chairwoman the role of the contractor and being able to implement innovations free of the constraints imposed by the IRS, or the shackles or whatever word we want to use, because I think when you look at private industry, they have gone through a tremendous amount of change in the last few years that we in government have been either unable or unwilling to do. And if you will just address that to Chairwoman Johnson.

Ms. RICHARDSON. Absolutely.

Mr. LAUGHLIN. It is not necessary to respond at this time.

Chairman JOHNSON. I would also like when you do that to be as

specific as possible because that phrase caught my eye, too.

What kinds of things are in the existing contracts that are impediments to innovation? And what would be the cost of rebidding? How can we get out from under that? There may be ways that we can help you do that. I can understand how contracts developed a number of years ago might not serve you well now, but I would like a better understanding of what the existing contract impediments are and how you plan to overcome them, and that leads me to another question I wanted to bring up, which is: Why are you serving as your own prime contractor? And what are the pros and cons of that? The FAA did that in trying to develop their new air traffic control computer network.

Mr. LAUGHLIN. I was going to make reference to that.

Chairman JOHNSON. I used to be on the Public Works Committee, too.

Mr. LAUGHLIN. You all were doing it that long ago?

Chairman JOHNSON. That is right, and sat through the first years of that planning and were really appalled how every time we had a report, the report sounded great, but in the end the system didn't work.

Mr. LAUGHLIN. I would just like to add, Commissioner, that what Chairwoman Johnson has asked is so important because I went through those aviation hearings on implementing a new computer system for the FAA and our airliners, and I may be wrong, but it was in the billions of dollars that had been spent, and we still don't have a modern system after years, because they sold the company to get rid of the contract. I think it would be irresponsible on the

part of this Oversight Subcommittee not to have a full and com-

plete report on that and to look at it closely.

Chairman Johnson. It is instructive that the Congress came to the conclusion that the only way you could keep a system that large technologically current was to get it out from under the bureaucracy. So what are the barriers within the structure of the bureaucracy and the way the bureaucracy proceeds that are interfering with the accomplishment of this architectural issue and some of the contractual problems? We will look forward to that report, and I would be happy to get those on the Committee who are most interested together for an informal discussion if that would be more appropriate.

There are a couple of other issues that I did want to pursue if

my colleague is finished.

Mr. LAUGHLIN. Absolutely. I yield back the balance of my time. Chairman JOHNSON. The National Research Council did criticize the security features of TSM. That is extremely important. If we can't guarantee people information security, we are going to have very big problems on our hands. And as we move into TeleFile and CyberFile, if there are doubts about the security of the TSM system, it will simply fail.

So how can the IRS expand the filing options to the Internet and assure information security? What are you doing to assure that?

Ms. RICHARDSON. Well, we don't want to develop and are not planning to develop any of our systems without proper regard to security. There is a security concept of operations and security architecture that is under development, and I think we elaborated more on that in the written testimony. I would be happy to give a fuller briefing to the Committee about what we are doing. Specifically, as to any kind of direct filing or Internet-related filing, we would never go forward with any program until it could be assured that such a program could be made absolutely secure.

Chairman JOHNSON. How do you respond to the criticisms that the National Research Council made about your security features?

Are you familiar with them?

Ms. RICHARDSON. I will let Mike Dolan answer the question.

Mr. Dolan. A couple, Madam Chairman. We actually had a fairly robust closeout conversation with them around this point, and I think the thing that we took most from their observation and the follow-on conversation was that the architecture that we are currently operating under, which is a very distributed—it is a process by which an awful lot of our data gets distributed widely in the organization. The NRC said to us two things:

One is that we have got to be very conscious that to overlay on that kind of an architecture the security we want and need is a costly undertaking. And so they encouraged us to be sure that we made the right kind of choices surrounding business needs of distributed data versus cost of securing it the way you need to. They encouraged us to make the right kinds of tradeoffs and that we do that up front, recognizing the kinds of cost consequences of our decision.

The other thing they asked us to be sure we weren't doing was looking only at internal security. They acknowledged that we had placed an inordinate amount—not inordinate, an extraordinary

amount of inside security in all of our plans and architectures, and they said they wanted evidence that the way we were building the security levels was also mindful of all the sort of outside penetration attempts that we have seen elsewhere in government.

I think we will be able to satisfy hopefully both you and them

from our security architecture that we have done exactly that.

Chairman JOHNSON. Thank you. We will be interested in discuss-

ing that information with you when you have completed it.

I want to just conclude by raising the issue of the Service Center Recognition Image Processing System, SCRIPS. SCRIPS was developed to electronically scan instead of manually keypunch into the IRS computer system certain tax forms. In February of this year, last month, an internal audit report prepared by the IRS Inspection Service was critical of the SCRIPS performance and questioned whether it was ready for wide-scale use.

Has SCRIPS met all the performance goals originally set for it? Has SCRIPS captured all information on the forms it scans or only part of the data? What have been the results from the SCRIPS

Pilot Program?

Ms. VAN ALFEN. Madam Chairman, SCRIPS has not met all of the performance goals that we had in place and that we had originally set and desired that the system would deliver on. However, this year it is functioning much better. We have made some upgrades and some workflow improvements and it is showing much improved performance this year.

We encountered some major integration issues with it early on, but we feel comfortable that we are working through those, and it

is performing much better.

Chairman JOHNSON. So what percentage of the workload that you originally scheduled for SCRIPS has the IRS had to shift to the traditional processing pipelines perhaps last year and this year?

Ms. VAN ALFEN. Last year we did have to shift some of our workload back to the pipeline processing because we were not able to process it all the way through.

Chairman JOHNSON. Fifty percent?

Ms. VAN ALFEN. On one particular form type, yes, that is correct.

Chairman JOHNSON. And how about this year?

Ms. VAN ALFEN. This year we are still processing 50 percent of one form type. However, in the other forms that we have identified, we are processing those through the system.

Chairman JOHNSON. OK. Thank you very much. That concludes my questions, and I thank the panel for being with us this morn-

ing.

Mr. Herger has been detained and has been unable to join us before we have completed our discussion, and we will have some follow-on questions for you which he will submit and we will enter in the record.

[The following was subsequently received:]

WALLY HERGER

20 DISTRICT CALIFORNIA
REASE REPAY TO
WASHINGTON OFFICE
2433 RAYBERS, HOUSE OFFICE 1/2021 225-3076
OISTRICT OFFICES
55 FORDER HOUSE OFFICES

□ 55 INDEPENDENCE CIRCLE, SUITE 104
CHID. CA 95926
916, 893, 8303
□ 410 HIMPTED DALE, SLIFE 115
RELIGIOUS CA 36602
916, 223, 5899



COMMITTEE ON WAYS AND MEANS

COMMITTEE ON THE BUDGET

Congress of the United States

House of Representatives Washington, BC 20515-0502

March 21, 1996

Margaret Richardson Commissioner Of The Internal Revenue Service Room 3000 1111 Constitution Avenue, NW Washington, District of Columbia 20224

Dear Madam Commissioner:

Sierra Pacific Industries, a significant employer in my district, filed a request for a private letter ruling on January 30, 1996 concerning the application of Internal Revenue Code section 1374 to the harvesting of timber. Upon receipt of a favorable ruling, Sierra Pacific intends to make an election to be taxed as an S corporation. The ruling requested was entirely consistent with a series of recent private letter rulings issued by the Service. Nonetheless, Sierra Pacific was recently informed that the request is being closed without the issuance of a ruling. I understand that the Service has taken similar steps with respect to several other taxpayers and has decided to suspend consideration of private rulings in the area while it analyzes the treatment of timber harvesting under section 1374.

I have two major concerns to bring to your attention with regard to this matter. First, as you are well aware, the President has proposed legislation that would make it prohibitively expensive for companies such as Sierra Pacific to elect S corporation status. The administration recently announced that the effective date of the proposed legislation is being delayed to January 1, 1997. Therefore, it is imperative that the Service conclude its review of this issue in a timely fashion so that Sierra Pacific, as well as any other affected taxpayer, will have the opportunity to apply for a favorable ruling. Resolving the issue in a manner favorable to taxpayers will do little good if they are then prevented from making an S election because of the proposed section 1374 legislation.

The second major concern I have is that by closing down the private ruling process in this area, the Service has shut down the flow of factual information concerning timber operations. My constituent informs me that timber operations vary widely from region to region and state to state. It is possible that these factual differences could be important in your consideration of the overall treatment of the timber industry. Therefore, I urge the service not to resolve these complex issues in a limited factual setting, but to seek input from and be open to meeting with affected taxpayers prior to reaching a final decision.

I am confident that you will take these concerns seriously, and look forward to your response. In particular, I would like your commitment to see that this issue is resolved in a timely fashion.

Sincerely,

Wally Herger Member of Congress



DEPARTMENT OF THE TREASURY INTERNAL REVENUE SERVICE WASHINGTON, D.C. 20224

The Honorable Wally Herger House of Representatives \Washington, D.C. 20515-0502

APR 23 1996

Dear Congressman Herger:

Thank you for your March 21, 1996 letter in which you expressed concern that the § 1374 timber issues involved in a ruling request submitted by one of your constituents, Sierra Pacific Industries, be resolved in a timely and orderly fashion. We appreciate your concerns in this matter and assure you that we are dedicated to resolving the complex issues involved in this matter as soon as possible.

In your letter, you expressed two particular concerns regarding your constituent's ruling request. First, you expressed concern that our temporary ruling suspension on § 1374 timber issues may have inadvertedly cut off the flow of information from other taxpayers that could prove helpful in resolving those very issues. We do not intend to close off the flow of factual information or decide these issues in a limited factual setting. We are willing to meet in a presubmission conference with any taxpayer contemplating a ruling request to learn of that taxpayer's factual setting and hear any arguments they wish to make. In fact, we held such a presubmission conference with your constituent on January 30, 1996, in which we learned a great deal about the timber industry in northern california. At that conference, Sierra Pacific Industries' tax representative submitted a well thought out memorandum discussing a number of the complex issues involved. This memorandum is being thoroughly considered in resolving the § 1374 timber issues.

Second, you pointed out that the President has proposed legislation that would make it prohibitively expensive for companies such as Sierra Pacific Industries to elect S status on or after January 1, 1997. You stated that it is therefore imperative that we conclude our review of this matter in a timely and orderly fashion. We assure you that the § 1374 timber issues are receiving our foremost attention, and we are confident that a resolution of these issues will occur well before the January 1, 1997 effective date of the President's proposed legislation. Furthermore, you can rest assured that once a resolution has been reached, your constituent will be promptly notified. If your constituent resubmits the ruling request, we also intend to grant expeditious treatment to ensure that they receive our response well before January 1, 1997.

If you have any further concerns or questions regarding this matter, please feel free to contact me at (202) 622-7720 or Attorneys Mark Jennings and Gene Raineri of my staff at (202) 622-7530.

Sincerely.

Bernita L. Thigpen (Acting) Deputy Assistant Chief Counsel (Corporate)



Sierra Pacific Industries

P.O. Box 496028 • Redding, California 98049-6028 • (916) 378-8000 March 27, 1996

Internal Revenue Service 1111 Constitution N. W. Washington, DC 20224

Attention: Dwayne Vincent

Ladies and Gentlemen:

CONSENT TO DISCLOSE TAX INFORMATION

I hereby authorize the Internal Revenue Service to disclose return information regarding a ruling request filed by Sierra Pacific Industries on January 30, 1996 and closed without a ruling on February 29, 1996, as that term is defined in section 6103(b) of the Internal Revenue Code, to Members and staff of the Subcommittee on Oversight of the House Committee on Ways and Means.

I am aware that without this authorization, this information is confidential and protected by law under the Internal Revenue Code.

Taxpayer's Name:

Sierra Pacific Industries

Taxpayer ID Number:

Address:

19794 Riverside Avenue Anderson, CA 96007

Yours very truly,

SIERRA PACIFIC INDUSTRIES

Jon D. Gartman

Secretary and Director of Taxes

JDG/br

Chairman JOHNSON. Thank you, Commissioner Richardson.

Ms. RICHARDSON. Thank you very much.

Chairman JOHNSON. And my thanks to your staff.

The next panel is Lynda Willis, the Director of Tax Policy and Administration Issues at the U.S. GAO.

I would ask my colleague to take over for a few minutes, and I will return very shortly. But I would like you, Ms. Willis, to proceed.

STATEMENT OF LYNDA D. WILLIS, DIRECTOR, TAX POLICY AND ADMINISTRATION ISSUES, GENERAL GOVERNMENT DIVISION, U.S. GENERAL ACCOUNTING OFFICE: ACCOMPANIED BY RONA B. STILLMAN, PH.D., SCIENTIST. COMPUTERS AND TELECOMMUNICATIONS, ACCOUNTING AND INFORMATION MANAGEMENT DIVISION

Ms. WILLIS. Thank you, Madam Chairman. We are pleased to be here today to participate in the Subcommittee's inquiry into the Internal Revenue Service's financial condition for 1996, the status of the 1996 filing season, and the administration's fiscal year 1997 budget request.

With me today is Dr. Rona Stillman, who is the GAO executive responsible for our work evaluating tax systems modernization.

My statement today makes the following four points:

First, programs directed at identifying noncompliance and, to a lesser extent, assisting taxpayers absorbed a substantial portion of the 1996 budget cuts.

Second, the 1996 filing season seems to be going more smoothly

than last year's in some key respects.

Third, TSM continues to be plagued by numerous management and technical weaknesses that put additional investments at risk.

And, fourth——

Mr. LAUGHLIN [presiding]. Could I interrupt you. Did the Commissioner leave somebody from her staff here?

[A show of hands.]

OK. Very good. Please proceed.

Ms. WILLIS. And, fourth, although IRS has taken some actions to address our previous concerns with compliance initiatives, some issues remain.

Turning first to IRS' 1996 financial condition, in fiscal year 1996 IRS had an appropriation of \$7.3 billion, \$160 million less than its 1995 appropriation and \$860 million less than the President requested. To accommodate its reduced budget, IRS took a number of actions. These included a hiring freeze, offering early outs without incentives, reducing awards, travel, and overtime costs, reducing the work hours of seasonal employees, and cutting back on the use of nonpermanent staff.

In making its staffing reductions, IRS wanted to ensure that it had enough staff to process tax returns and issue refunds in a timely manner. As a result, programs directed at identifying noncompliance, such as document matching, automated collection, or ACS, and questionable refund detection, absorbs most of the cuts. Affected to a lesser extent were taxpayer assistance programs.

Turning to the filing season, preliminary information indicates that in certain key aspects the 1996 filing season is progressing much more smoothly than the 1995 season. However, there are still several outstanding concerns. Available data indicate that IRS has been successful in not adversely affecting its ability to do what it sees as its most critical functions: Processing returns and issuing refunds. As of March 15, IRS Service Centers had processed 71 percent of the paper individual income tax returns they had received and had done so within about the same 8- to 13-day cycle time as last year. IRS officials told us that refunds may be going out a couple of days slower than last year, but still within the 40 days that IRS promises taxpayers.

The performance of IRS' new document imaging system, or SCRIPS, that we just talked about has improved in 1996, but remains far from the level of performance IRS had originally expected. Although IRS made changes to SCRIPS after the 1995 filing season to enhance its performance, we are concerned that more specific performance expectations for SCRIPS this filing season were not established. Without those expectations, it is difficult to

determine which enhancements were cost beneficial.

As of March 15, the number of individual income tax returns filed electronically had increased substantially compared to the same time last year. This is true even though the overall number of returns filed as of this date was down slightly. Most of the growth was in TeleFile, which went nationwide this year. Although the number of electronic returns is higher than last year, as of March 15 it was still about 16 percent fewer than the number filed at the same point in time 2 years ago.

Last year IRS also took several steps to better ensure that taxpayers were entitled to their refunds, dependents, and earned income credits they claimed. The most visible of these involve the delay of millions of refunds to allow IRS time to verify Social Security numbers and to do compliance checks. Although those efforts appear to have significant deterrent effect, they were not without problems. Specifically, IRS identified many more missing, invalid, and duplicate Social Security numbers than it was able to pursue and ended up releasing the refunds without resolving the problems and delayed millions of refunds for taxpayers that had valid Social Security numbers to check for duplicates, but also ended up releasing those refunds without doing the checks.

IRS took steps this year to address some of the problems it encountered in 1995. It has said it is being more selective in deciding which cases to investigate and which refunds to delay. Statistics indicate that IRS is, indeed, delaying fewer refunds this year. The impact of delaying fewer refunds is also reflected in higher telephone accessibility rates for the 1996 filing season, according to IRS, although the rate is still very low. Accessibility is at 20 percent as of March 9, up from 8 percent for the 1995 filing season. IRS attributes the improved accessibility primarily to the lower number of calls received this year. The number of calls received is down approximately 40 percent.

Although IRS has apparently been able to process returns and issue refunds this year without significant problems, staffing cuts in other areas could be affecting its ability to serve taxpayers and

identify questionable refunds.

In 1996 IRS closed 93 walk-in assistance sites and reduced the operating hours for some of the remaining 442. IRS data show that walk-in sites have served about 16 percent fewer taxpayers through March 9 than in the same time last year. However, I should note that taxpayers are able to obtain assistance and service from other sources, although maybe not as easily.

IRS' primary program for detecting questionable refund claims also absorbed staffing cuts in 1996, a decrease of 31 percent. IRS told us that because of the Staff Reduction Program, procedures were changed to better target staff efforts. In an attempt to recoup most of these staff reductions, IRS' budget request for 1997 includes \$21 million and 230 FTEs for the Questionable Refund Program. This is part of the revenue initiative I will discuss later.

Moving now to TSM, which began in 1986, is key to IRS' future business vision. IRS' 1997 budget request for TSM is \$850 million, \$155 million more than 1996. We have raised significant concerns about TSM and continue to believe that additional investments are at risk and we are concerned about how effectively IRS can use the requested funds until it corrects fundamental technical and mana-

gerial weaknesses.

While IRS has initiated a number of activities and made some progress in addressing our recommendations to improve the management of TSM, none of our recommendations have been fully satisfied. As a result, we do not believe that IRS can make effective use of TSM systems development funds at this time. Our concern is heightened by the fact that IRS would not give us specific information on its plans for spending the \$850 million requested for TSM in 1997. Information that is available on the \$155 million increase raises additional concerns in that it contains an additional \$29 million for CyberFile. We believe CyberFile is poorly developed and does not adequately address the security requirements needed to protect taxpayer data.

Finally, IRS 1997 budget request contains \$359 million for revenue protection or compliance initiatives. To help Congress deliberate on that portion of their request, you asked that we summarize our past work on compliance initiatives. That work has raised

the following issues:

First, prior to fiscal year 1995, IRS consistently used at least some compliance initiative funds to cover budget shortfalls in base operations. To ensure IRS spent 1995 fiscal year compliance initiative funds as intended, its ability to use those funds for other pur-

poses was restricted by Congress.

Second, until recently, IRS was unable to track actual revenues generated by the compliance initiatives. For the last several years, IRS has been implementing an enforcement revenue information system that is intended to report the actual revenue from compliance programs. However, in the past, concerns have been expressed about the reliability of that data, and IRS has been working to resolve those concerns. We will test the reliability of the data as a part of our audit of IRS' 1996 financial statements.

Third, for several years, we have encouraged IRS to shift its collection focus from revenue officers, who generally collect delinquent taxes through face-to-face contact with taxpayers, to more productive processes like ACS that emphasize early telephone contact. Al-

though IRS reduced the number of revenue officer positions in its 1995 compliance initiative, it planned to hire about 750. IRS is now diverting some revenue officers to ACS to mitigate the impact of

ACS' 1996 staffing reductions.

The \$359 million is expected to fund 3,830 additional compliance staff. According to IRS, most of those staff are for areas such as ACS and document matching that were significantly affected by the 1996 staffing cuts. However, IRS' budget shows that total compliance staffing is expected to increase by only 2,390 positions in 1997. Almost all of the difference is because the budget also includes a decrease of over 1,300 FTEs for law enforcement. According to IRS, the decrease will come from more traditional enforcement job categories such as revenue officers.

One effect of the increases and decreases in the 1997 budget, if implemented as described, would be to alter the mix of collection staffing toward the kind of mix we have advocated in the past.

In conclusion, although IRS has made some changes, certain questions remain regarding the revenue initiatives. Specifically, one, will IRS spend the additional funds for additional compliance staff? Two, does IRS have reliable data on the revenue generated by its enforcement activities? And, three, will IRS be able to achieve the new staffing mix?

That concludes my statement. I would be happy to answer any

questions you may have.

[The prepared statement follows:]

STATEMENT OF LYNDA D. WILLIS DIRECTOR, TAX POLICY AND ADMINISTRATION ISSUES GENERAL GOVERNMENT DIVISION U.S. GENERAL ACCOUNTING OFFICE

Madam Chairman and Members of the Subcommittee:

We are pleased to be here today to participate in the Subcommittee's inquiry into the Internal Revenue Service's (IRS) financial condition for 1996, the status of the 1996 filling season, and the administration's fiscal year 1997 budget request for IRS.

Our statement is based on work we have been doing for the Subcommittee and our past reviews of filing season activities, Tax Systems Modernization (TSM), and compliance initiatives.

In our statement, we address the following four issues:

- -- According to IRS officials, IRS' actions to reduce staffing through a hiring freeze and an early-out program were not sufficient to cover the labor-cost shortfall that resulted from an approximately \$860-million reduction in IRS' budget request for fiscal year 1996. To further cover the shortfall, IRS reduced support costs, cut the number of hours for seasonal employees, and reduced the number of nonpermanent staff. In making these reductions, IRS wanted to ensure that it had enough staff to process tax returns and issue refunds in a timely manner. As a result, programs directed at identifying noncompliance and, to a lesser extent, assisting taxpayers, absorbed most of the cuts.
- -- Notwithstanding the budget cuts that affected some of IRS' taxpayer assistance programs, this year's filing season seems to be progressing more smoothly than did last year's in some key respects. Most importantly, IRS is delaying fewer refunds this year while it validates Social Security Numbers (SSN) and Earned Income Credit claims. IRS revised its procedures for 1996 in an attempt to better target its efforts and impose less of a burden on honest taxpayers. Also, telephone accessibility has improved, and more taxpayers are using alternative return-filing methods. Although this filing season appears to be going more smoothly in these respects, there are still several concerns. For example, (1) although telephone accessibility has improved, it is still very low; (2) IRS closed many walk-in sites this year that had provided assistance to taxpayers in the past; and (3) the document imaging system being used to process some individual income tax forms is still not meeting its original expectations.
- -- The administration is requesting almost \$8 billion for IRS for fiscal year 1997, an increase of \$647 million from fiscal year 1996. Of that request, \$850 million is for TSM, \$155 million more than in 1996. TSM is plagued by numerous managerial and technical weaknesses that we identified in a July 1995 report. Although IRS has initiated actions in response to these weaknesses, those efforts provide little assurance that the weaknesses will be corrected in the near term. As a result, we believe that additional investments in TSM are at risk.
- The largest program increase in IRS' fiscal year 1997 budget request is \$359 million for certain compliance programs. Our past work on compliance initiatives identified several problem areas, including (1) IRS' inability to fully implement past initiatives, (2) the inaccuracy of IRS' tracking of the revenue from such initiatives, and (3) the focus of past collection initiatives on hiring revenue officers instead of more productive collection staff.

¹Tax Systems Modernization: Management and Technical Weaknesses Must Be Corrected If Modernization Is To Succeed (GAO/AIMD-95-156, July 26, 1995).

Although IRS has taken some actions to address our concerns, some issues remain, particularly in terms of the reliability of IRS' data.

OVERVIEW OF IRS' FINANCIAL CONDITION IN FISCAL YEAR 1996

IRS' fiscal year 1996 appropriation was \$7.3 billion. That amount was about \$860 million less than the President requested for fiscal year 1996 and about \$160 million less than IRS' fiscal year 1995 appropriation.

In June 1995, anticipating possible reductions from the amount the President had requested for fiscal year 1996, IRS began taking steps to reduce its staffing levels. On June 30, 1995, IRS announced a hiring freeze. Earlier in 1995, IRS had announced an early-out program without incentives for employees affected by its district office and regional office consolidations. After enactment of its final appropriation, IRS reopened the early-out program through February 3, 1996, and made it available to all employees. About 1,690 staff retired as a result of this program.

To further cut costs, IRS officials said that IRS (1) reduced employee cash awards by 20 percent, for a savings of \$11 million; (2) reduced travel and overtime costs by \$49 million; (3) reduced the workhours of seasonal employees by as much as 40 percent; and (4) cut back on the use of nonpermanent staff, such as term employees. IRS officials also said that the above actions enabled them to avert a reduction-in-force (RIF). According to IRS officials, by the time IRS would have been able to implement a RIF for fiscal year 1996, the cost would have exceed the savings.

As of March 1, 1996, according to IRS officials, IRS had about \$140 million in unfunded mandatory nonlabor costs for fiscal year 1996. Some of those unfunded costs were for telecommunications, postage, and rent. IRS officials said that they are hoping to resolve these unfunded costs without having to resort to furloughs.

Part of the \$140 million shortfall stems from lower user-fee receipts than expected. IRS' fiscal year 1996 appropriation assumed a receipt of \$119 million from user fees. IRS now expects to receive from \$60 to \$70 million in such fees for fiscal year 1996.

Staffing Cuts in the Document Matching Program and at Automated Collection System Call Sites

As noted earlier, IRS' actions to reduce labor costs involved steps directed at seasonal and nonpermanent staff. Most of IRS' seasonal and non-permanent staff (1) help process tax returns during the filing season, (2) assist taxpayers either at walk-in offices or over the telephone, and (3) work in compliance programs that do not require face-to-face interaction with taxpayers. IRS officials told us that in deciding which areas to cut, IRS wanted to ensure that it could process tax

 $^{^2}$ According to IRS officials, IRS considered eliminating all cash awards but decided against that option.

³Although IRS' seasonal staff work less than a traditional 40-hour week, 52-week schedule, they are permanent employees.

^{&#}x27;Term employees are hired for a finite period of time. During that time, they have employment rights similar to those of permanent employees. However, they can be released once their term expires.

returns and issue refunds in a timely manner. As a result, most of IRS' staffing cuts affected its compliance programs, with some cuts in the taxpayer service area.

According to IRS officials, the two compliance programs that employ the largest number of seasonal and term staff are (1) the Document Matching program, through which IRS identifies taxpayers that either underreport their income or do not file required tax returns, and (2) the Automated Collection System (ACS), through which IRS staff try to contact delinquent taxpayers or nonfilers by telephone and resolve the delinquency. Because IRS' cost-cutting measures for fiscal year 1996 focused on seasonal and nonpermanent staff, these two programs were significantly affected.

Document matching

Through the Document Matching program, IRS matches income reported on tax returns with information provided by third parties, such as wage information from employers and interest and dividend information from financial institutions. Those matches are to identify taxpayers that underreported their income (underreporters) and those that did not file required tax returns (nonfilers).

According to IRS, it spent about 1,950 staff years on underreporter activities in fiscal year 1995 and closed 4.1 million cases with recommended tax assessments of \$1.7 billion. Because of staff reductions, IRS estimates that it will spend about 1,300 staff years on underreporter activities in 1996—about a 33-percent reduction—and close about 1.5 million fewer cases. IRS estimates that its assessments from closed cases will be \$1.4 billion, \$300 million less than in 1995. IRS' matching program also identifies taxpayers who have not claimed refunds to which they are entitled. In fiscal year 1995, IRS issued \$120 million in refunds through that program. IRS expects that amount to drop to \$95 million in 1996 because of staff reductions.

Also under the Document Matching program, IRS creates returns for nonfilers using information documents provided by third parties. According to IRS, it spent about 600 staff years on that effort in fiscal year 1995, closed about 810,000 cases, and assessed \$1.9 billion. Because of staff reductions, IRS estimates that it will spend about 370 staff years on this effort in fiscal year 1996—about a 38-percent reduction—and close about 180,000 fewer cases. IRS estimates that assessments from closed cases will be \$1.3 billion, \$650 million less than in 1995.

Automated Collection System

Once a tax delinquency or delinquent return is identified, IRS uses a three-stage process to collect the tax or secure the return. In the first stage, taxpayers are mailed a series of notices. If the case is not resolved at this point and meets certain criteria, it is transferred to ACS. At this stage, IRS staff in call sites contact the taxpayer or nonfiler by telephone. If the case remains unresolved at this point and meets certain criteria, it is transferred to a revenue officer, who is to visit the taxpayer or nonfiler or take other steps to secure the delinquent return and/or collect the delinquent tax.

Because of various factors discussed in the appendix, ACS had a significant number of seasonal, term, and other than full-time permanent staff at the end of fiscal year 1995--66 percent more than it had at the end of fiscal year 1994. As a result, ACS was targeted for a significant staff reduction when IRS decided to reduce the number of hours for seasonal staff and not extend appointments for term employees.

IRS officials subsequently decided that the budget impact on ACS was too severe. To mitigate the impact, IRS negotiated with the National Treasury Employees Union to allow the detail of about 300 revenue officers and other compliance staff to ACS. These details are to remain in effect for at least 1 year. IRS officials said that they plan to revisit this agreement with the union once IRS knows its budget situation for fiscal year 1997.

THE 1996 FILING SEASON SEEMS TO BE GOING MORE SMOOTHLY THAN LAST YEAR'S IN CERTAIN KEY RESPECTS

On the basis of our past filing season reviews, we had several questions going into the 1996 filing season:

- -- How will IRS' staffing reductions for fiscal year 1996 affect its ability to process returns and assist taxpayers?
- -- Will last year's drop in the number of electronic filings be reversed?
- -- What can taxpayers expect in the way of refund delays in 1996?
- -- Will the steady decline in the accessibility of IRS' telephone assistance over the past several years continue?
- -- Has the performance of IRS' Service Center Recognition/Image Processing System (SCRIPS) improved?

As discussed below, preliminary information addressing these questions indicates that, in certain key respects, the 1996 filling season is progressing more smoothly than did the 1995 season. As also discussed below, however, there are still several concerns that we will be monitoring during our continuing assessment of filing season activities. Specifically, (1) although telephone accessibility is up, it is still very low; (2) IRS closed many walk-in sites this year that had provided assistance to taxpayers in the past; and (3) SCRIPS is still not meeting its original expectations.

Effect of Staffing Cuts on Filing Season

In deciding where to make the staffing cuts for fiscal year 1996, IRS wanted to make sure it had enough staff to do its most critical functions--process returns and issue refunds--in a timely manner. Available data indicate that IRS has been successful in that regard. As of March 15, 1996, IRS' 10 service centers had processed 71 percent of the paper individual income tax returns they had received (the same percent as last year), and the centers were processing that workload in about the same cycle time as last year (within an average of 8 to 13 days, depending on the type of individual income tax return filed).

IRS service center officials told us that refunds may be going out a couple of days slower than last year but still within the 40 days that IRS promises taxpayers in its customer service standards. Service center officials told us that IRS had decided to focus on meeting the 40-day standard in 1996 rather than incur the extra costs associated with trying to beat it. However, we were unable to verify whether the refund cycle time has changed because the data we use to track refund timeliness were not available at the time we prepared this statement.

Although IRS has apparently been able to process returns and issue refunds this year without any significant problems, staffing cuts in other areas could be affecting its ability to serve taxpayers and identify questionable refund claims.

Taxpayer service

In the taxpayer service area, IRS closed 93 walk-in assistance sites, reduced the operating hours of some of the 442 sites that remained open, and eliminated free electronic filing at 195 of the sites. According to IRS, the closed sites were selected on the basis of their historical volume of work and their proximity to other walk-in sites. As an indication of the effect of these closures and cutbacks, IRS data show that walk-in sites served about 1.7 million taxpayers from January 1 through March 9, 1996—about 16 percent fewer taxpayers than were served at the same time last year.

Walk-in sites provide various free services, including copies of the more commonly used forms and publications, help in preparing returns, and answers to tax law questions. There are other ways taxpayers can obtain those services free, although maybe not as easily.

Taxpayers needing forms and publications, for example, might find them at their local library or can get them by calling IRS' toll-free forms-ordering number. Our reviews of past filing seasons showed that taxpayers were generally able to get through to IRS when they called the forms-ordering number, and the forms distribution centers did a good job accurately filling orders. However, according to IRS, it will generally take from 7 to 15 workdays to receive what you order, if it is in stock. Taxpayers with access to a computer can download forms from Internet or the FedWorld computer bulletin board. Forms are also available on CD-ROM and through IRS' "fax on demand" service.

Taxpayers who need help preparing their returns and do not want to pay for that help might be able to take advantage of the tax preparation services offered at sites around the country that are part of the Volunteer Income Tax Assistance and Tax Counseling for the Elderly programs.

Taxpayers who need answers to tax law questions could call IRS toll-free tax assistance number (which we discuss later) or IRS TeleTax system, which has prerecorded information on about 150 topics. As of March 16, 1996, the number of tax law calls to TeleTax had increased by about 10 percent over last year (4.5 million this year compared with 4.1 million last year).

Still another option for free assistance is IRS' World Wide Web site on the Internet. Among other things, IRS' site includes copies of forms, information similar to that on TeleTax, and some interactive scenarios that taxpayers can use to help them answer some commonly asked guestions. IRS reported on March 18, 1996, that its World Wide Web site had been accessed more than 25 million times since January 8, 1996.

Questionable refund program

IRS' primary program for detecting questionable refund claims also absorbed staffing cuts in 1996. According to IRS data, the 10 service centers have been allocated a total of about 379 full-time equivalents for that program in fiscal year 1996 compared with 551 full-time equivalents in 1995—a decrease of 31 percent. IRS officials told us that, because of the staff reduction, program procedures were changed in an attempt to better target the staffs' efforts. We do not know the initial impact of these changes because we have not yet seen any statistics on the number of questionable refund claims detected in 1996. In an attempt to recoup most of those staff reductions, IRS' budget request for fiscal year 1997 includes \$21 million and 230 full-time equivalent positions for the questionable refund detection program. That request is part of the revenue protection initiative discussed later.

Alternative Ways of Filing

As of March 15, 1996, the number of individual income tax returns filed in ways other than the traditional paper format has increased substantially compared to the same time last year. That is true even though the overall number of returns filed as of March 15 was down slightly from last year. As shown in table 1, most of the growth in alternative filings is due to 1040PC and TeleFile. 5

Table 1: Individual Income Tax Returns Received, 1994-1996

Type of filing	March 15, 1996	March 17, 1995	March 18, 1994
Traditional paper	36,258,000	40,787,000	38,333,000
Electronic	9,811,000	9,259,000	11,647,000
TeleFile	2,379,000	592,000	459,000
1040PC	2,767,000	673,000	1,723,000
TOTAL	51,215,000	51,311,000	52,162,000

Source: IRS' Management Information System for Top Level Executives.

Growth in the use of 1040PC is due, in part, to the largest user rejoining the program after dropping out in 1995. The growth in TeleFile is due primarily to its expanded availability. It is now available nationwide; it was only available to taxpayers in 10 states in 1995. IRS' budget request for fiscal year 1997 includes \$7 million to allow expansion of TeleFile to other forms and taxpayers. Although IRS has made substantial progress in expanding the use of TeleFile and further expansion seems logical, it is important to note that only about 12 percent of the more than 20 million 1040EZ taxpayers who IRS estimated would be eligible to use the system in 1996 had actually used it as of March 15. In past reports, we have discussed the benefits of TeleFile to taxpayers (e.g., reduced filing time, fewer errors, and quicker refunds) and the presumed benefit to IRS in reduced processing costs. In addition to expanding TeleFile, it seems that IRS could increase participation in the program by (1) determining why many currently eligible users are not participating and (2) taking steps to address any identified barriers to their fuller participation.

SUnder TeleFile, certain taxpayers who are eligible to file a Form 1040EZ are allowed to file using a toll-free number on touch-tone telephones. Under the 1040PC method, a taxpayer or tax return preparer uses computer software that produces tax returns in an answer-sheet format. The 1040PC shows the tax return line number and the data (dollar amount, name, etc.) on that line. Only lines on which the taxpayer or preparer has made an entry are included on the 1040PC. Under the third alternative filing method, electronic filing, returns are transmitted over communication lines to an IRS service center, where they are automatically edited and processed.

For the 1995 filing season, IRS required that preparers provide taxpayers with some type of descriptive printout or legend that explained each line on the taxpayer's 1040PC return. According to an official of a private tax preparation firm that had been the largest user of 1040PCs, the firm chose to stop participating in 1995 rather than incur the extra cost associated with providing the legend.

Last year was the first year since electronic filing started in 1986 that the number of returns received electronically decreased from the number received the prior year. Although the number of electronic returns is on the rise this year compared with last, the number filed as of March 15 was still about 16 percent fewer than the number filed at the same time 2 years ago. As we recommended in October 1995, if IRS is to reach its goal of 80 million electronic returns in 2001, it needs to (1) identify those groups of taxpayers who offer the greatest opportunity to reduce IRS' paper processing workload and operating costs if they were to file electronically and (2) develop strategies that focus resources on eliminating or alleviating impediments, such as the program's cost, that inhibit those groups from participating.

Refund Delays

Last year, IRS took several steps in an attempt to better ensure that persons were entitled to the refunds, dependents, and Earned Income Credits they were claiming. The most visible of those efforts involved the delay of millions of refunds to allow IRS time to verify SSNs and do compliance checks. Although those efforts appeared to have had a significant deterrent effect (e.g., preliminary information indicates that 1.9 million fewer dependents were claimed in 1995 than were in 1994), they were not without problems.

IRS (1) identified many more missing, invalid, and duplicate SSNs than it was able to pursue and ended up releasing the refunds without resolving the problems and (2) delayed millions of refunds for taxpayers whose returns had valid SSNs to check for duplicate SSNs but ended up releasing those refunds after several weeks without doing the checks. Many taxpayers and practitioners were surprised that IRS delayed some refunds even if all of the SSNs on the return were good. They were also upset that IRS split some refunds--issuing part of the refund and delaying the rest--but only honored a taxpayer's direct deposit request for the first part of the refund.

As we noted in our report to the Subcommittee on the 1995 filing season, IRS identified fewer fraudulent returns during the first 9 months of 1995 than it did during the same period in 1994, and the percentage of fraudulent refunds it stopped before issuance declined. Neither we nor IRS know whether those decreases were due to a decline in the incidence of fraud or a decline in the effectiveness of IRS' detection efforts. The Director of IRS' Office of Refund Fraud expressed the belief that there were fewer fraudulent returns to be identified in 1995. He opined that the additional controls IRS implemented in 1995 and knowledge of those actions had deterred persons from filing fraudulent returns.

IRS took steps this year to address some of the problems it encountered in implementing its new procedures in 1995. For example, IRS has said that it is being more selective in deciding which cases to investigate and which refunds to delay this year-trying to focus its resources on the most egregious cases and minimize the burden on honest taxpayers.

Statistics on the number of notices sent to taxpayers in 1996 concerning SSN problems and refund delays indicate that IRS is indeed delaying fewer refunds. As of March 9, 1996, IRS had mailed about 56-percent fewer refund-delay notices than at the same time last year. Another indicator that fewer refunds are

Tax Administration: Electronic Filing Falling Short of Expectations (GAO/GGD-96-12, Oct. 31, 1995).

⁶We limited our comparison to the first 9 months because IRS had not compiled data for the last quarter of 1995.

being delayed in 1996 is the decrease in the number of "where is my refund" calls to IRS. Taxpayers wanting to know the status of their refunds can call TeleTax and get information through the use of an interactive telephone menu. This filing season, as of March 16, 1996, IRS reported receiving 26.5 million such calls--a decrease of about 15 percent from the 31.0 million it reported receiving as of the same time last year.

Telephone Accessibility

For the past several years, taxpayers have had difficulty reaching IRS by telephone. As we reported to the Subcommittee in December 1995, IRS data showed that (1) an estimated 46.9 million callers made 236 million call attempts to IRS for tax assistance between January 1 and April 15, 1995 and (2) IRS was able to respond to only 19.2 million of those attempts—an accessibility rate of 8 percent.

Accessibility has improved this year, although it is still low. IRS data for January 1 through March 9, 1996, showed 63.3 million call attempts, of which 12.7 million were answered—an accessibility rate of about 20 percent. As of the same time last year, IRS reported receiving about 107 million call attempts, of which 11.7 million were answered—an accessibility rate of about 11 percent. As the data indicate, a major reason for the improved accessibility is the significant drop in call attempts. IRS attributed that drop to (1) fewer refund delay notices being issued, as discussed earlier; (2) a slippage in the number of returns filed; and (3) IRS efforts to publicize other information sources, such as Internet.

SCRIPS

In our report to the Subcommittee on the 1995 filing season, we noted that IRS' new document imaging system--SCRIPS--did not perform as expected, leading to increased returns processing costs and lower-than-expected productivity. To For example, SCRIPS had such significant downtime that two of the five service centers that were using SCRIPS stopped using it to process Forms 1040EZ. As a result, IRS had to redirect more of the Form 1040EZ processing workload to its manual data entry system. After the 1995 filing season, IRS identified hardware and software upgrades that would be needed to correct the SCRIPS performance problems. IRS made some of those changes for the 1996 filing season.

Our discussions with IRS officials and our review of processing rate data indicate that SCRIPS' performance has improved in 1996. Specifically, SCRIPS is processing at faster rates in three of the five centers and operating with less system downtime in all five centers. However, the two centers that stopped using SCRIPS to process Forms 1040EZ last year are experiencing slower processing rates than those of last year. Despite the improved performance, SCRIPS is far from the level of performance IRS had originally expected. For example, IRS originally planned to be processing all Forms 1040EZ on SCRIPS by 1996; it now expects to process about 50 percent of the Forms 1040EZ received in 1996 on SCRIPS. The remaining forms are being processed through IRS' manual data entry system.

Although IRS made changes to SCRIPS and performance has improved, we are concerned that IRS did not establish more specific performance expectations for SCRIPS this filing season. IRS specified volume expectations by form type, but it did not

⁹The 1995 Tax Filing Season: IRS Performance Indicators Provide Incomplete Information About Some Problems (GAO/GGD-96-48, Dec. 29, 1995).

¹⁰GAO/GGD-96-48.

establish expectations for improvements in processing rates or reductions in system down time that should result from the enhancements made for the 1996 filing season. Without those expectations, it will be difficult for IRS to determine which enhancements were cost beneficial. We are currently reviewing SCRIPS and plan to report our results later this year.

ADDITIONAL INVESTMENTS IN TSM ARE AT RISK GIVEN CURRENT MANAGERIAL AND TECHNICAL WEAKNESSES

TSM, which began in 1986, is key to IRS' vision of a virtually paper-free work environment in which taxpayer account updates are rapid and taxpayer information is readily available to IRS employees to respond to taxpayer inquiries. IRS' fiscal year 1997 request for TSM is \$850 million, a \$155 million increase from IRS' proposed operating level for fiscal year 1996. We continue to believe that TSM is a high risk and are concerned about how effectively IRS can use the requested funds until it corrects some fundamental technical and managerial weaknesses.

The Treasury, Postal Service and General Government Appropriations Act for 1996 "fenced" \$100 million in TSM funding until the Secretary of the Treasury reports to the Senate and House Appropriations Committees on IRS' progress in responding to the recommendations we made in a July 1995 report on TSM.11

Many of our recommendations were intended to correct critical IRS management and technical weaknesses by December 31, 1995. Without these corrections, IRS will not have the sound management and technical practices it needs to successfully meet TSM objectives in a cost effective and expeditious manner. A recent National Research Council report on TSM had a similar message. The Council's recommendations parallel the recommendations we made involving IRS' (1) business strategy to reduce reliance on paper, (2) strategic information management practices, (3) software development capabilities, (4) technical infrastructures, and (5) organizational controls.

In our March 14, 1996, testimony before the Subcommittee on Treasury, Postal Service and General Government, House Committee on Appropriations, we assessed IRS' progress in responding to our recommendations. ¹³ Because IRS' progress report on implementing our recommendations was not finalized, our assessment was based on several follow-up meetings with IRS officials and a review of various planning documents. According to the Deputy Secretary of the Treasury, the Department is currently reviewing IRS' progress report and plans to submit it to Congress "as soon as possible."

IRS has initiated a number of activities and made some progress in addressing our recommendations to improve management of information systems; enhance its software development capability; and better define, perform, and manage TSM's technical activities. However, none of these steps, either individually or in the aggregate, has fully satisfied any of our recommendations.

As a result, we do not believe that IRS can make effective use of TSM systems development funds at this time. Our concern is heightened by the fact that IRS would not give us specific information on its plans for spending the \$850 million being

¹¹GAO/AIMD-95-156.

¹²Continued Review of the Tax Systems Modernization of the Internal Revenue Service-Final Report, Computer Science and Telecommunications Board, National Research Council, 1996.

¹³Tax Systems Modernization: Status of Tax Systems Modernization. Tax Delinquencies, and the Fotential for Return Free Filing (GAO/T-GGD/AIMD-96-88, Mar. 14, 1996).

requested for TSM in fiscal year 1997. IRS' budget request contains some general information on its plans for the \$155 million increase over the proposed operating level for fiscal year 1996. However, the information provided raises additional concerns. In this regard, IRS is requesting an additional \$29 million for Cyberfile, an electronic filing system. Earlier this week, we testified that Cyberfile is a poorly developed system that does not adequately address the security requirements needed to protect taxpayer data. 14

FISCAL YEAR 1997 BUDGET REQUEST INCLUDES \$359 MILLION FOR REVENUE PROTECTION INITIATIVES

In every year but one from 1990 through 1995, Congress has appropriated IRS funds for various compliance initiatives aimed at increasing IRS' enforcement staff with the expectation that the increase would produce more revenue. For fiscal year 1995, Congress appropriated \$405 million for compliance initiatives. In estimating the revenue that would be generated from those initiatives--\$9.2 billion--IRS assumed that Congress would continue to provide \$405 million for the additional staffing over the next 4 years. However, Congress did not provide the second-year funding installment for fiscal year 1996.

IRS' fiscal year 1997 budget request includes \$359 million for "revenue protection initiatives". Although the name has changed, these initiatives are directed toward achieving the same goal as were previous compliance initiatives—to increase revenue. To help Congress deliberate on this portion of IRS' budget request, you asked that we summarize our past work on compliance initiatives. That work focused on the following issues:

- -- Before fiscal year 1995, IRS consistently used at least some of the compliance initiative funds for purposes other than those that Congress intended. Specifically, IRS used these funds to cover budget shortfalls in base operations. As a result, many of the past compliance initiatives were never fully implemented. To ensure that IRS spent fiscal year 1995 compliance initiative funds as intended, the Appropriation Committees restricted IRS' ability to use those funds for other purposes.
- Before fiscal year 1995, IRS only tracked the staffing and revenue associated with an initiative. Using this approach, IRS could claim that compliance initiatives had met their revenue goal even if IRS' base staffing had declined, which was often the case. We recommended that IRS provide Congress with information on the total revenue achieved-from both base staffing and compliance initiative staffing-to ensure that Congress had a more accurate picture of IRS' total compliance program. 15 IRS revised its tracking approach for fiscal year 1995.
- -- Although IRS revised its tracking approach, we cannot yet comment on the accuracy of the revenue figures in IRS' tracking reports. Until recently, IRS had to estimate the amount of revenue derived from its compliance efforts because it was unable to track actual revenue-regardless of whether it was generated from compliance initiative staff or base staff. For the last several years, IRS has been implementing an Enforcement Revenue Information System (ERIS) that is intended to report the actual revenue from

¹⁴Tax Systems Modernization: Management and Technical Weaknesses Must Be Overcome to Achieve Success (GAO/T-AIMD-96-75, Mar. 26, 1996).

¹⁵Tax Administration: Congress Needs More Information on Compliance Initiative Results (GAO/GGD-92-118, July 31, 1992).

various compliance programs. In the past, we have discussed concerns about the reliability of ERIS data, and IRS has been working to resolve those problems. We plan to test the reliability of ERIS data as part of our audit of IRS' fiscal year 1996 financial statements.

-- Although we generally supported the fiscal year 1995 compliance initiatives, we did not support hiring more revenue officers. For several years, we have encouraged IRS to shift its collection focus from revenue officers, who generally collect delinquent taxes through face-to-face contact with taxpayers, to more productive processes like ACS, that emphasize early telephone contact. Although IRS subsequently reduced the number of revenue officers for that initiative, it still planned to hire about 750 in fiscal year 1995. As noted earlier, IRS is now diverting some revenue officers --who are paid at higher rates than ACS staffir-to ACS to mitigate the impact of ACS staffing reductions.

The \$359 million included in IRS' fiscal year budget request for the revenue protection initiatives is expected to fund 3,820 additional compliance staff. According to IRS, most of those staff are for areas, such as ACS and Document Matching, that were significantly affected by fiscal year 1996 staffing cuts.

Despite the 3,820 additional staff associated with the revenue protection initiatives, IRS budget shows that total compliance staffing is expected to increase by only 2,390 positions in fiscal year 1997. Almost all of that difference is because IRS' budget also includes a decrease of 1,341 full-time equivalents for tax law enforcement. That decrease is part of IRS' contribution to reductions in base programs to reduce the federal deficit. According to IRS, the decrease of 1,341 positions will come from the more traditional enforcement job categories—those, such as revenue officers and revenue agents, that engage in face-to-face audit and collection activities. IRS' budget states that although "these positions still comprise the lion's share of IRS enforcement efforts, they also represent, on the margin, the least efficient use of IRS resources." According to IRS officials, these staff reductions will be achieved through attrition.

Thus, one effect of the increases and decreases in IRS' compliance staffing for fiscal year 1997, if IRS' budget request is approved and is implemented as IRS has described, would be to alter the mix of that staffing. IRS would have fewer revenue officers, for example, and more ACS staff--the kind of mix that we have advocated in the past.

In conclusion, although IRS has made some changes, there are certain questions that remain appropriate in discussing the revenue protection initiatives: (1) will IRS spend the additional funds for additional compliance staff? (2) does IRS have reliable data on the revenue generated by its enforcement activities? and (3) will IRS be able to achieve the new staffing mix?

That concludes $\ensuremath{\mathsf{my}}$ statement. We welcome any questions that you $\ensuremath{\mathsf{may}}$ have.

APPENDIX APPENDIX

FACTORS AFFECTING ACS STAFFING FOR FISCAL YEAR 1996

Factors surrounding IRS' organizational and business restructuring led to ACS having a large number of seasonal, term and other than full-time permanent staff at the end of fiscal year 1995. As a result, ACS was targeted for a significant staff reduction given IRS' cost-cutting approach for fiscal year 1996.

IRS' customer service vision calls for combining into 23 customer service sites the work of at least 70 organizational units that employ staff who do not have face-to-face interactions with taxpayers. These centers are to employ staff who will work primarily by telephone to assist taxpayers, collect delinquent taxes, and adjust taxpayer accounts. As part of this consolidation, IRS is to close 10 of its 20 ACS sites.

After IRS announced which 10 sites would be closed, two things happened. First, ACS employees who could find other positions left ACS. Some of these employees were hired for revenue officer positions that became available as part of the fiscal year 1995 compliance initiatives. Second, the 10 ACS sites that were scheduled to close could hire only term and seasonal staff, according to an IRS official. Therefore, at the end of fiscal year 1995, ACS had 448 seasonal, term, and other than full-time permanent staff--66 percent higher than the number at the end of fiscal year 1994.

Mr. LAUGHLIN. Thank you very much.

Dr. Stillman, are you testifying?

Ms. STILLMAN. I am available to answer any questions you may have in the TSM area.

Mr. LAUGHLIN. Thank you.

Ms. Willis, how long do you think it will take the IRS to put the TSM back on the right track? And how will we know if the new track is any better than the current track?

Ms. WILLIS. Let me refer that question to Dr. Stillman.

Ms. STILLMAN. We made a series of recommendations in a July 1995 report, over a dozen recommendations, specific recommendations telling IRS what they needed to do to put themselves in a better position to invest their large budget in it well, to build their systems well, and to manage it well. We have dates on those ranging from June 1995 to improve their investment strategy and prioritize their investments through December 1995 to make technical improvements.

At that time IRS agreed with the recommendations, and in their written comments took no exceptions to the dates. At this point they have implemented none of those recommendations.

Mr. LAUGHLIN. That was my question.

Ms. STILLMAN. They have completely implemented none.

Mr. LAUGHLIN. Have you seen any implementation of any of the

12 that you recommended 9 months ago?

Ms. STILLMAN. We have seen activities aimed at making progress on those recommendations. Those activities neither individually nor in the aggregate completely addressed any of the over a dozen recommendations.

Mr. LAUGHLIN. And when you made the recommendations, the IRS agreed with them?

Ms. Stillman. They did so in writing at the back of that report.

Mr. LAUGHLIN. And you have seen no implementation?

Ms. STILLMAN. We see no effective implementation at this point.

Mr. LAUGHLIN. It is kind of like me saying I am going to marry you and then not show up.

Ms. STILLMAN. Absolutely.

Mr. LAUGHLIN. How will the intervention of the Treasury Depart-

ment affect the timetable and acquisition costs for TSM?

Ms. STILLMAN. We did not evaluate that specifically, and I don't have that answer for you now. There are joint activities including Treasury and IRS. I am unable to tell you what the time or quality effect of that is.

Mr. LAUGHLIN. Dr. Stillman, this may be something you should answer. In the prepared statement by Ms. Willis, you talk about having seen no steps that satisfy your recommendations, and then you say, "we do not believe the IRS can make effective use of TSM system development funds at this time."

What do you recommend?

Ms. STILLMAN. It is quite clear that IRS cannot control from an investment perspective or from a technical perspective their very large budget, in the neighborhood of \$850 million or \$700 million or \$1 billion annually.

What would seem to be more prudent would be for IRS to identify what it needs for basic day-to-day operations, what it needs to

continue current operations. Major developments over that, I think, should have to be justified convincingly to the Congress, perhaps in supplement appropriations requests.

Mr. LAUGHLIN. Is this an area where the existing contracts should be reviewed for modification to determine whether any of the outside contracting agencies would be more appropriate to

manage the development of TSM?

Ms. STILLMAN. We made one recommendation in our July 1995 report directly addressing the use of contractors, and that was that in all new contracts, IRS should require that their contractors perform software development at a repeatable level, the Software Engineering Institute's level 2. That would give you some confidence that, in fact, IRS could deliver repeatably products of reasonable quality, on time, and within budget.

There is no evidence that IRS requires all its contractors to perform at SEI level 2, and, in fact, CyberFile is an example of a contractual effort that IRS has undertaken since our report that does not require that its contractors build software at SEI capability

level 2.

Mr. LAUGHLIN. Ms. Willis, early in your remarks, you said some issues remain dealing with TSM, and I am not smart enough or knowledgeable enough to keep up. Did you address those concerns later in your testimony?

Ms. WILLIS. The issues that remain with TSM, as Dr. Stillman alluded to, are the issues associated around the managerial and technical weaknesses that we identified that we attempted to address through our recommendations.

Mr. LAUGHLIN. Are there any other issues remaining that either you or Dr. Stillman have not testified to at this point in your testimony?

Ms. WILLIS. No.

Mr. LAUGHLIN. What are the advantages and disadvantages of having the IRS act as its own prime contractor? And would you recommend that the IRS continue as its own prime contractor, or

would you recommend they seek outside help?

Ms. Stillman. We have had some discussions with IRS and its integration support contractor in the past. It is unclear to me what IRS means by a prime contractor, what prime contractor responsibilities connote to IRS. It is unclear to me what obstacles they see in using the integration support contractor as an integration contractor. IRS has explained to me that the integration support contractor acts in an advisory role. I have asked the question, What precludes IRS from taking the integration support contractor's advice in every case or in most cases? And I have never gotten an answer that I understood.

Mr. LAUGHLIN. When will the IRS be capable of making realtime, online adjustments to a taxpayer's account? What benefits would the taxpayer and the IRS enjoy from such a capability? And do you have any idea when the IRS will have its computers connected in such a fashion as it will not have to transport the data tapes around the country by airplane?

Ms. WILLIS. Mr. Laughlin, I don't think there is any question that there are great benefits to the taxpayer and to IRS for IRS being able to immediately access and make corrections to taxpayer

accounts. It would help not only reduce taxpayer frustration in dealing with the IRS, but also would allow IRS to more efficiently address taxpayer concerns.

I will ask Dr. Stillman to elaborate, but my understanding at this point in time is that we do not have any confidence in when

IRS will be able to provide that service to taxpayers.

Ms. STILLMAN. As a level 1 organization, which IRS itself knows it is, IRS develops systems without using disciplined processes. It doesn't use tools to estimate how systems will perform, on what schedule they can deliver, and what they will cost, and therefore there is no basis for any confidence in any of their estimates in any of those areas.

Mr. LAUGHLIN. Last year the IRS experienced problems in the testing of SCRIPS. It is my understanding SCRIPS is supposed to image the data on Form 1040EZ, Form 941, and Form 1040PC. How well is SCRIPS performing during this filing season? And does it catch all the data on the forms it scans or only part of the data?

Ms. WILLIS. This filing season SCRIPS is working better than it did last year. In the five centers where SCRIPS is in place, it has less downtime than it did last year. In the two centers that ceased using SCRIPS last year, they are reporting they are able to continue using it, but it is operating at a much slower rate than what they had anticipated.

Right now they are capturing about 50 percent of the 1040EZ forms through the SCRIPS process, and the rest are being done

through manual data entry.

Mr. LAUGHLIN. How effective was the IRS Antifraud Compliance Program during the 1995 filing season? And in connection, how many taxpayers who filed accurate returns last year nevertheless had their refunds delayed? Earlier in your testimony, you talked about invalid Social Security numbers and refunds, if you can work that into your response. And I have got to tell you in my area of the country, which is south Texas—you probably thought I was from the North—we hear a lot about Americans retiring to Mexico, and then their Social Security numbers getting jumbled up, and never having paid into the system. Can you respond to that?

I asked too many questions. Let me start over.

How effective was the IRS antifraud program? And talk about the—

Ms. WILLIS. The IRS 1995 fraud detection efforts were effective. As the Commissioner noted in her testimony and we noted in ours, there was a reduction in the number of dependents claimed. There were a number of fraudulent or noncompliant refunds identified and held up. However, there were also a number of taxpayers who filed accurate returns with appropriate Social Security numbers who also had their tax returns held up while IRS intended to look for duplicate uses of SSNs. That match was never done, and as a result, these refunds were held up and were ultimately released without any follow-up checks being done.

In addition, for some of the returns where there were missing or invalid SSNs, IRS went and worked with the taxpayer and discovered there was a fairly high no-change rate. By that I mean that the information on the return, while the missing or invalid SSN

was incorrect, the information regarding the refund was correct, and the taxpayer did, indeed, warrant it.

I am not sure that I understand your question about Mexico.

Mr. LAUGHLIN. Forget that part. I will rephrase the question, though. Is there a satisfactory system for pursuing invalid Social Security numbers? And let me direct your attention to credit card abuse to focus where I am trying to go.

I had a credit card stolen, a gasoline company credit card, and I didn't know it. But the company called me after several days because there were charges being made outside the geographic area where I normally charged. I thought it was wonderful. I had no clue it was missing.

Is there anything in the IRS system that will trigger them, trip them that there is an invalid Social Security—how do they address that?

Ms. WILLIS. If you were attempting to file a return electronically and the Social Security number is either missing or invalid, IRS filters will kick that back and not allow you to file it. So they do have a system within the Electronic Filing Program to identify missing or invalid SSNs which prohibits the filing of the return.

In terms of paper returns, they have a process where the return is actually filed, and then they go back through and look for missing and invalid SSNs. They do not have a system that would allow them to say that your SSN was used on somebody else's return and notify you to that effect.

Mr. LAUGHLIN. Now, let me go to Mexico, but we can go to any other country where Americans will retire and move, and a substantial amount of people do that. People will retire, move to another country, and receive their refunds or their Social Security using numbers that often get transferred around, and then you have fraud. What is in the system to prevent that from happening?

Ms. WILLIS. Sir, we really haven't done any work to look at that question.

Mr. LAUGHLIN. Madam Chairman, that completes my questioning, and I not only yield the time back to you, but your Chairman's chair, also.

Chairman JOHNSON. Thank you, Congressman Laughlin, for taking over in that interim. I will recognize Mr. Portman.

Mr. PORTMAN. Thank you, Madam Chair. And, Mr. Chair, you

did a superb job as always.

I was a little disappointed in your brief response with regard to the SCRIPS Program. I come from Cincinnati and have toured the Covington Service Center where SCRIPS is up and going, and about a year ago I had a very upbeat assessment from the local IRS office as to how it was working. I actually witnessed it working. And it is my view that if this can work, in fact, we will see instant modernization in the sense that there will be less need for manual input. And if we can't do SCRIPS right, it seems to me it doesn't bode well for TSM.

So my thought is, we need a little more information as to what is wrong with SCRIPS, why isn't it working, why do we have the downtime—do you have any other information? Have you all spent much time on SCRIPS? I know there has been an internal audit, I guess, but has GAO spent much time looking at that?

Ms. WILLIS. We are currently in the process of doing an evaluation of SCRIPS and identifying what the problems have been, how it is, indeed, performing against expectations over time, and whether the improvements that are being made are bringing it up to the performance levels expected. We expect to be able to report out on that later this year.

Mr. PORTMAN. Is it your thought, with regard to the 1040EZ and perhaps some of the other forms that are easier to scan, that this is a solution to some of the existing problems in the system, mak-

ing it more efficient, expediting returns and so on?

Ms. WILLIS. The ability to optically scan returns would definitely make certain parts of the system more efficient. It would reduce the amount of manual data entry that is required and allow IRS to process the returns more quickly.

Mr. PORTMAN. Reducing mistakes? Ms. WILLIS. Reducing mistakes.

Mr. PORTMAN. That would seem to me to be an obvious benefit.

Ms. WILLIS. Right.

Mr. PORTMAN. It is not officially part of TSM; is that correct? Is it a separate undertaking?

Ms. WILLIS. My understanding is it is included under the TSM

umbrella.

Mr. PORTMAN. OK. I know in Covington it has already begun.

Ms. WILLIS. Right.

Mr. Portman. Perhaps I should be directing these questions to our friends from Treasury or IRS, but it is something that is up and going, I know, in our area through the Covington Service Center.

Ms. WILLIS. Right, it is up and running in five sites across the United States.

Mr. PORTMAN. OK. And is your report coming out in the short term after the filing season? Or when would you expect to have it ready?

Ms. WILLIS. It will be later this summer.

Mr. PORTMAN. Later this summer?

Ms. WILLIS. Right after we have a chance to get the data and

analyze this year's filing season.

Mr. PORTMAN. And obviously you are taking into account the internal audit that has been done. The report done by the Service with regard to SCRIPS?

Ms. WILLIS. Yes.

Mr. Portman. I for one and I think this Subcommittee would be very interested to hear more about what you all are coming up with and to see whether this is an area where we can make some progress. Again, if we can't do it with SCRIPS that would seem more fundamental than some of the other TSM undertakings we were discussing, it seems to me we have a real problem. So we need to focus on that, and if it doesn't work, then move on to other ways to gain efficiency.

Thank you, Madam Chair.

Chairman JOHNSON. We do have a vote that has been called. Let me very briefly ask a question, because I share the gentleman's interest in SCRIPS, and I appreciate his pursuing that questioning. In your estimation, was there a problem in the development of SCRIPS with input from the frontline people, from the users? Or

was that not a problem?

Ms. WILLIS. That is one of the issues that we are looking at right now. To date, our work has been focused more on how well SCRIPS is performing, whether it is meeting the performance expectations processing the returns that IRS expected it to process.

Chairman JOHNSON. I realize it is not the same issue as ICP, but

I wondered if there was a parallel there.

I am sobered by your comments in your testimony. You believe that "None of the steps that have been taken, either individually or in the aggregate, has fully satisfied any of our recommendations. As a result, we do not believe that the IRS can make effective use of TSM systems development funds at this time."

Are there no projects under the Systems Modernization Program that you think can benefit from additional investment this year?

Ms. Stillman. When we evaluated IRS' capability and maturity to develop systems in general, we asked them to identify specific pockets of expertise that they had, centers of excellence where we would go and assess how well, at those centers of excellence, IRS developed software. It turned out they had none, and nowhere within IRS are they developing software using disciplined repeatable processes. Nowhere.

Chairman JOHNSON. And you also go on to say that the IRS would not give you specific information on its plans for spending

the \$850 million?

Ms. STILLMAN. That is correct. The kind of information that would have provided some evidence of progress would be a prioritized list of investments and for each their cost and their benefits and how they would contribute to the overall business goals of tax systems modernization.

We would have liked that list prior to their rescoping and postrescoping efforts so we could evaluate the value added by those rescoping efforts. We have gotten none of that, not before and not after, and no explicit criteria for making those prioritizations. They say they have done that, and we have asked them precisely what criteria they used. We have been unable to get that information.

Chairman JOHNSON. Thank you very much. Are there other ques-

tions by the Members of the Subcommittee?

[No response.]

Chairman JOHNSON. We will adjourn this panel, and I thank you for your testimony. It was very helpful to us at a difficult time.

Ms. WILLIS. Thank you. Ms. STILLMAN. Thank you.

Chairman JOHNSON. I thank the panel.

I would ask Mr. Clagett to make his opening statement before we go to vote, and then we can be thinking about that. That is a 5-minute window for you, Mr. Clagett. But then we will all hear that, and whenever there is a series of votes, it is harder for Members to return. So some of us will be back, but it will be at least 20 minutes. Perhaps the staff meanwhile can find out how many votes there are, and we will be able to give people a better idea of what time we will resume.

Mr. Clagett, chairman of the Committee on Continued Review of the Tax Systems Modernization of the IRS, the National Research Council. Mr. Clagett, we are happy to have you and appreciate the input of the National Research Council throughout this process.

STATEMENT OF ROBERT P. CLAGETT, CHAIRMAN, COMMITTEE ON CONTINUED REVIEW OF THE TAX SYSTEMS MODERNIZATION OF THE INTERNAL REVENUE SERVICE, NATIONAL RESEARCH COUNCIL

Mr. CLAGETT. I am glad to be here. Indeed, I am the chairman of the committee. I am also a lecturer at the University of Rhode Island now and am a member of the National Academy of Engineering.

As I think you know, the National Research Council is the operating arm of the National Academy of Sciences, the National Academy of Engineering, and the Institute of Medicine, chartered way back in 1863, the original NAS. Its charter is to advise the government, and through them, that is what this committee has been doing.

The project I chaired involved an original Committee followed by an extension, and there were some membership changes during that time. We have produced six reports, and my remarks are going to refer to the latest report, which was distributed in February 1996. That publication is the "Continuing Review of the Tax Systems Modernization of the Internal Revenue Service," and it was released to the IRS in December 1995.

I want to point out that the IRS was the sponsor of this project, but consistent with the NRC policy, it did not preview any of the recommendations. The Committee, the original and the extension, that I chaired was rich in both private sector experience with large systems and large systems developments and with technical expertise.

My Committee and I strongly believe that modernization of the information systems at the IRS is very important. Indeed, that is not the question at all. The Service has a lot of old computer equipment, and it certainly is difficult for them to maintain it. Only a part of the returns processing now is computerized, with taxpayer paper files the main mode of operation still. Modernization would enable better customer service and better agency and government performance.

In the course of our work, we focused on the ability of the IRS to modernize while monitoring its progress. We made several recommendations relating to the IRS structure and management, and they have been implemented. Among them, for example, they have established focused units to address the needs in architecture and privacy and elevated positions in human resources and, most importantly, as you have heard, for the management of the tax systems modernization, the modernization executive position, which is now an Associate Commissioner level.

Through such actions, the IRS has improved its organization involved with TSM. A central concern of our committee was management, and it runs the spectrum from vision through planning and implementation. Quoting from our 1996 report, "The committee believes that 'success' starts with a concise business vision, a well-organized modernization process, a clear systems architecture, a complete development plan, and a strong set of metrics to determine

progress." The IRS has created a vision statement, and it has begun the process of reengineering its business processes. However,

these efforts remain somewhat disjointed from TSM.

Of greatest concern are the enduring deficiencies in technical management. It is in this area that progress must be made if TSM is going to succeed. Those deficiencies show up in the IRS' own software and system development organization, its lack of a concise statement of the system architecture, its approach to and slow rate of improvement in development processes, and its incomplete attention to system and data security. The committee frequently expressed concerns in the six reports that I have mentioned over the 5 years about the lack of experience in large systems development and implementation within the IRS management. This deficiency shows up in the rate of internal progress and in the nature and effectiveness of interactions with contractors involved in TSM development.

I would say here, as I have said repeatedly to the IRS, that the Service should not have had in-house capability to take on such a large project when it started. That condition was no embarrassment. But it should have assessed the size and complexity in developing such a large project and then acquired the trained, experienced management team needed to direct it. In fact, that is the way most private industries approach such a project. Instead, it relied on competent in-house management who were—and are—generalists who have advanced through the IRS through many years. They are good people. They know how to run the IRS as it exists today. At the same time, they have not grasped our recommendations as to what it takes to develop a huge information system such

as TSM.

Quoting again from our report, "The IRS must implement the fol-

Chairman JOHNSON. Excuse me, Mr. Clagett. You are at the point in your testimony where you are going to go into detail on your recommendations.

Mr. CLAGETT. Fine.

Chairman Johnson. I am going to ask you to suspend because we only have 3 minutes left to vote.

Mr. CLAGETT. Fair enough.

Chairman JOHNSON. We have two votes, and we will reconvene about 12:30.

Mr. CLAGETT. That is fine.

[Recess.]

Chairman Johnson. Mr. Clagett, we will resume. We have Mr. Hancock here and myself, and we will resume. Please feel free to take your time.

Mr. CLAGETT. Thank you very much. I will start off where I

stopped.

Quoting from our report, "The IRS must implement the following recommendations immediately and forcefully; otherwise, the goals of the TSM effort are in serious jeopardy"—and that is a quote, of course, from our report. And I am going to comment and tick off those basic recommendations.

Recommendation 1, Acquire more technical management expertise, through both hiring and contracting, starting with a highly

qualified Chief Information Officer to fill the vacant position. And, of course, I am pleased to note that they have now done so. It might be interesting to talk some time about the effort they had and the frustration in trying to find somebody within the constraints both of salary and the position, of the caliber they wanted.

Chairman JOHNSON. If I may interrupt you, I am glad you mentioned that, because that is something we should come back to and that we will be very interested in, particularly in your perspective on it, since you do see this in many areas where the government is seeking scientific or other expertise. I know when we worked on the air traffic controllers issues, we simply had to change the pay structure in order to get people into the more difficult areas like O'Hare and Kennedy.

Mr. CLAGETT. Well, perhaps after I finish we can talk, because I have, indeed, thought about the way in which an agency can go about it, and maybe we can talk some more about that.

Chairman JOHNSON. Thank you.

Mr. CLAGETT. So I am pleased they have got such a person. I hope he has the background and experience that will really help TSM become effective.

The second recommendation was to effectively integrate the operational and technical goals by developing a proper set of metrics to measure performance. That is, at the very outset, know what it is you want to accomplish; in other words, know when TSM has succeeded, and then start to develop the systems, instead of developing the systems and then trying to figure out what those goals should be. Those metrics are still not in place.

Recommendation 3, Develop an adequate architectural definition and design led by the Systems Architects Office—they do have one now—and enforced by a strong set of interface specifications for key applications of systems—and that includes security—and a process for maintaining them properly. I would be glad to talk some more about that as well.

Significantly increase the scope, level of effort, management attention, and tools devoted to security development. Next, the SEI level 2 issue that was mentioned by GAO is very important. I would add not only for internal, but if, indeed, their contractors are at level 2 and beyond, I doubt that there is a significant amount of communication between the two if inside the IRS they are at level 1. That would be tough.

Recommendation 5, Implement an overall process improvement plan. I have just gone into that. That is the SEI level 2 challenge.

Recommendation 6, Focus efforts on the Integrated Case Processing System. That is the target system we picked. The main message here is pick one, do it well, develop it, test it, put it in the field, prove it out, and use your best people to do that, and then move on to the next one. We think integrated case processing is central to the whole TSM effort, and that is why we recommend that project.

Absent sufficient followthrough, new approaches to TSM may be necessary. We have thought about what alternatives there are. One would be to assess, justify, and fund each component project individually. Another possibility is to outsource the whole system as a project. The committee believes, however, that correcting the defi-

ciencies that have been identified and strengthening management is the best course of action for both the IRS and the country. That is the tone, as you know, of our report. We have expressed concern with the problems we have raised here and that we have raised previously, I might add. In fact, this last report specifically talks about how many times we have raised over the 5 years most of these same problems.

So we suggest that some ongoing mechanism be established that can both advise the Commissioner and foster constructive interaction between the IRS and its oversight organizations to assure the best possible focus, decisionmaking, and communication.

With that, I thank you and I will be glad to try to answer any

questions you have.

[The prepared statement follows:]

Statement of

Robert P. Clagett Chairman of the Committee on Continued Review of the Tax Systems Modernization of the Internal Revenue Service National Research Council, Member of the National Academy of Engineering, and Lecturer at the University of Rhode Island

Good Morning, Mr. Chairman and members of the Committee. 1 am Robert P. Clagett, lecturer at the University of Rhode Island and chairman of the National Research Council's Committee on Continued Review of the Tax Systems Modernization of the Internal Revenue Service. 1 am also a member of the National Academy of Engineering. The National Research Council is the operating arm of the National Academy of Sciences, National Academy of Engineering, and Institute of Medicine, chartered by Congress in 1863 to advise the government on matters of science and technology.

The project that I chaired involved an original committee followed by an extension with some membership changes. It produced six reports over a period of five years. My remarks today will draw from the February 1996 publication. Continuing Review of the Tax Systems Modernization of the Internal Revenue Service, which was released to the Internal Revenue Service in December 1995. The IRS was the sponsor for this project, but consistent with NRC policy did not preview the findings and recommendations. The committee, original and extension, that I chaired was rich in private sector experience with large systems development and management as well as technological expertise.

My committee and I strongly believe that modernization of the information systems of the IRS is very important. The Service still has a lot of old computer equipment, which is difficult to maintain. Only a part of returns processing is computerized, with taxpayer paper files the main mode of operation. Modernization would enable better customer service and better agency and government performance. In the course of our work we focused on the ability of the IRS to modernize, while monitoring its progress. We made several recommendations relating to IRS structure and management that have been implemented. Among them, for example, are establishment of focused units to address needs in architecture and privacy and elevation of positions with responsibility for human resources and for management of Tax Systems Modernization (the Modernization Executive position, now with Associate Commissioner status). Through such actions the IRS has improved its organization.

A central concern of our committee was management, running across a spectrum from vision through planning and implementation. Quoting from our 1996 report, "The committee believes that 'success' starts with a concise business vision, a well-organized modernization process, a clear systems architecture, a complete development plan, and a strong set of metrics to determine progress." The IRS has created a vision statement and it has begun a process of re-engineering its business processes. However, these efforts remain somewhat disjointed from TSM.

Of greatest concern are the enduring deficiencies in technical management. It is in this area that progress must be made if TSM is to succeed. Those deficiencies show up in the IRS' own software and system development organization, its lack of a concise statement of the system architecture, its approach to and slow rate of improvement in development processes, and its incomplete attention to system and data security. The committee frequently expressed concern about the lack of experience in large systems development and implementation within IRS management. This deficiency shows up in the rate of internal progress and in the nature and effectiveness of interactions with contractors involved in TSM development.

I would say here, as I have said repeatedly to the IRS, that the Service should not have had the inhouse capability to take on such a large project when it started. That condition was no embarrassment. But it should have assessed the size and complexity of developing such a large project and then acquired the trained, experienced management team needed to direct it. Instead, it relied on competent in-house managers who were—and are—generalists who have advanced within IRS for many years. These are good people who know how to run the IRS as it exists today. At the same time, they have not grasped our recommendations as to what it takes to develop a huge information system such as TSM.

Quoting again from our report, "The IRS must implement the following recommendations immediately and forcefully, otherwise the goals of the TSM effort are in serious jeopardy:

- "Recommendation 1. Acquire more technical management expertise, through both hiring and contracting, starting with a highly qualified Chief Information Officer to fill the vacant position.
- I am pleased to note that the position has recently been filled. I sincerely hope the new CIO has the background and experience to help TSM be effective. Qualified, trained, and experienced managers are needed at other levels as well.
 - "Recommendation 2. Effectively integrate operational and technical goals by developing a proper set of metrics to measure performance.
 - "Recommendation 3. Develop an adequate architectural definition and design, led by the Systems Architects Office and enforced by a strong set of interface specifications for key applications or systems, and a process for maintaining them properly.
 - "Recommendation 4. Significantly increase the scope, level of effort, management attention, and tools devoted to security development.
 - "Recommendation 5. Implement an overall process improvement plan. Specifically, require mature software and systems development processes across the entire development organization within 2 years, reaching maturity level 2 on the Software Engineering Institute Capability Maturity Model for Software (CMM) and maturity level 2 on the most pertinent process areas of the Industrial Collaboration Systems Engineering Capability Maturity Model.
 - "Recommendation 6. Focus efforts on the Integrated Case Processing (ICP) project, applying the best talent within the IRS, to demonstrate a mature development ability, to develop processes and procedures for all IRS projects, and to determine the long-term needs of the re-engineered IRS. Furthermore, TSM funding for projects that do not support the focus project directly should be reduced until definite improvement is shown."

Absent sufficient follow-through, new approaches to TSM may be necessary. One possibility would be to assess, justify, and fund each component project individually. Another possibility is to outsource the whole system as a project. The committee believes, however, that correcting the deficiencies it has identified and strengthening its management is the best course of action for the IRS and the country. It has expressed concern that the problems raised here, like some of the specific recommendations, have been raised previously. We therefore have suggested that some ongoing mechanism be established that can both advise the Commissioner and foster constructive interaction between the IRS and its oversight organizations, to assure the best possible focus, decision-making, and communication.

Chairman JOHNSON. I would like you to discuss more fully Recommendation 4, The scope, level of effort, management attention, and tools devoted to security development, but also perhaps in the context of developing also that management effort and the tools in other areas as well.

Mr. CLAGETT. You heard from the Commissioner and her staff that they have, indeed, after, I must say, substantial urging, developed what they call a security architecture. Early on in our discussion, they had not done what has to come first. In fact, you have to establish what level of privacy and privacy criteria you need before you can develop a security strategy. That took a lot of discussion, and I mentioned early on that one of the areas of organization that they improved was to bring in a high level privacy person, and that person immediately started with his staff to develop those sets of privacy criteria.

After that—and this has now only been 1½ years or so—they began to develop security requirements, and they do now have a security architecture document. What must follow that, however, is taking that security architecture document and now move down some levels to what are the specific security systems and system standards that are going to be used by the developers in each of those modules of TSM. That has not been done.

So as you see in the report, if you go into the field and talk to developers, they do not now have guidelines on what secure system is going to be used, either for their own projects or much less one that would be standardized across all the developments. And so they are doing what you would expect them to do. They don't wait. They go ahead and establish their own approaches to security.

Chairman JOHNSON. So the subcontractors or the contractors that IRS is working with have not been given the security document, the architectural document that the IRS has developed?

Mr. CLAGETT. They have been given an architectural document, but that does not establish specific standards that are going to be used throughout TSM. Those are not yet established.

Chairman JOHNSON. So the contractors really need a far more

specific document?

Mr. CLAGETT. That is a need both inside and outside. I must say that many of the systems are still developed and/or guided by internal IRS people. In fact, I think every one of the current service centers has a software development team, a large software development team. Their old mode used to be that they farmed out all of their development, essentially, to their regions. In those days, that was a strength in that it did, as you mentioned earlier, involve the field. But even in the old days, there was a lot of local input to a local design. However, it was designed for one area, and they had a lot of problems then duplicating it across all the other service centers.

They still use those development capabilities, and they are good. But our concern is that, absent a fully set group of standards for TSM, neither good interfaces nor communication among all those systems is going to happen nor will you see an effective security system.

Chairman JOHNSON. How do you explain that?

Mr. CLAGETT. How do I explain that? Well, I would like to back up because I have thought a lot about this after spending all these years looking at it. And knowing what most—I certainly won't say all, but what many private industry people would do, it goes something like this: You decide that you need a new system, a very large one, and so the first thing you do is decide what is it you want to have this new system accomplish when it is completed. Those are the metrics I am talking about. What kinds of performance do I want? And, of course, at the same time, or maybe even prior to that, they are asking themselves, when we get this capability or as we get it, how do we want to do business in a new way. And so those two things are done up front. Then most chief executive officers will look around and say we don't have the capability in-house to take on such a large system, so they will make a concerted effort to hire the best possible people they can get; some individual to lead the project who has large system experience and technical experience, and then expect that person to also bring in a cadre of outside people.

I don't think there is any reason, as I said in my testimony, for the IRS or any other agency to be embarrassed that they don't have the capability in-house when they start. What they don't tend to do is try to find outsiders who can lead with that kind of experience. Therefore, now I get back to why they do it the way they do it. In my view, they start doing the development, and in the case of TSM, as you have heard, TSM was preceded by some individual areas of development. And from that, they decided what we really want to do is a major one, the basis of which was to get all of the forms digitized as they come in so that they could then put them in the central database. Once you have got a central database, then you can pull out a taxpayer's complete file. Today, as you know, the front and back of the first page of the 1040 is all that is digitized. So all those other pages are not, and if you as a taxpayer ask them a question, they have to pull out those paper files, and that takes a lot of time.

The goal of TSM is to be able to pull up online most of that. In fact, one of the most meaningful metrics that was established some years ago in the business vision was to be able to respond to tax-payers' questions something like 80 percent of the time on the first call. It is a great goal, and it would make a wonderful thing. It requires all of this to be put together, starting with the database. It certainly means that all the systems they develop under TSM have got to communicate with each other, and that is why we are so worried about the architecture and the standards.

So when IRS, absent that concept, started, I believe what they did was start with the development and then say, maybe under some of our prodding and GAO's, we need to have an architecture and we need to have standards of interface. And that is backward, because the designers are way along in developing some systems, both inside the IRS and outside, without those standards. And that is why the committee has eventually become rather pessimistic that under the current mode you are really going to end up with a TSM. You are going to end up with a bunch of individual systems, but the chances of them both communicating with each other well and having a secure system are not great.

Chairman JOHNSON. Is hiring one skilled leader enough? Mr. CLAGETT. No.

Chairman JOHNSON. What are going to be the barriers, from your experience of watching this process, to hiring the complement of

people? I mean, is it money?

Mr. CLAGETT. Yes. We were pretty naive, I must say, as a group of people coming in here to look at what IRS was doing, and we really did think that what you needed to do was enhance what they are doing, get some people from the outside. The CIO search is a

good example.

I am reasonably sure that the Commissioner is very frustrated that, one, they had a nationwide search and hired a search firm—and they should speak to this, not me. But she, I know, was frustrated because she talked to me about getting input from our committee to help her, to get really top-drawer people. It turns out not many people even applied because the pay levels and so forth are well known. And it would have taken, I am sure, to get the kind of CIO that you would find in a comparable private firm taking on a project of the same size, it would take double or triple, at least, the salary they were able to offer.

So that has been a frustration for them. I don't know how—the only way I can conceive of it is not to make that person part of the civil service system, but to do what most private people do now. When they hire somebody at that level, it is usually on a contract. It is usually a contract for several years in which part of that large

remuneration depends on performance of the individual.

Chairman JOHNSON. Why didn't they choose that course of action?

Mr. CLAGETT. I don't know, and I am not even sure that it is available to them. I did hear that if they did such a thing under a contract, that contract has to come under, if they want to do it quickly, one of their existing contracts. So that individual would have to work with one of those contractors for some time. I don't really know much about that. I know that it is a problem for them.

But to your other question, would one person or a few help? One of the reasons we have been talking about it for so long was—well, I will say it bluntly. We were having a hard time really communicating with the IRS about what we meant about a systems architecture, about what we meant about changing the level of capability. And it is not surprising when you look at the background of the IRS folks. Most of them are excellent administrators, came up through IRS, as I said earlier. Their background is certainly limited on large projects.

So then we thought, well, the thing to do is to get some outside experts in. I now have a different opinion. I now—as Mr. Portman mentioned earlier, I really don't think it is effective for a Federal agency to either have onhand or try to get the level of experience in seldom approached, very large, complex computer systems. And so I think a much better method would be to have a prime contractor do the development, have enough internal expertise to develop the contract, and then have that prime contractor have cost, performance, time kinds of requirements, and even have incentives, or disincentives if they don't meet those deadlines. That would give

the prime the ability to hire the level of people they need, if they didn't have them, and get the job done.

There might be one other thing. I know there is some talk now about helping CIOs, that there may be—and I don't have any familiarity with the structure. There may be a way to have a cadre of people with that kind of experience available to loan to an agency when they start into such a project. But as was mentioned earlier, IRS is not the first to have a problem creating such a large system.

Chairman Johnson. I would appreciate your thoughts about what problems have to be dealt with to get qualified, trained, and experienced managers underneath the CIO or how to address that level of operation, whether that is more appropriately addressed through contract at this point or not. I think we have no shot of getting any support from the Appropriations Committee, nor should we, unless the Agency can be far more specific and unless there are some plans that really everybody agrees will bring to them the expertise they need in the time they need it to do the work that has to be accomplished.

Mr. CLAGETT. I would have to say that by now our committee,

at any rate, is rather pessimistic also.

Chairman JOHNSON. I do see that. On the other hand, the public need is to accomplish this, and we are either going to accomplish it badly or well. I mean, it is going to go forward because the computer capability of this agency is simply intolerable and much too outdated. If we don't do anything, it will simply break down, and there we will be. So we are going to have to go forward. And to avoid continued loss both of time and money, we really do have to help the Agency get the resources it needs and somehow press for-

ward on the proper use of those resources.

Mr. CLAGETT. I quite agree with that. As a matter of fact, even though I think, you know, long term—as I said, maybe it is not appropriate for an agency to do it—there is a substantial investment in TSM now, and our recommendation is, and certainly mine, I will refer to the committee's recommendation or at least comment on it, and that is, as is said in the report, to pick one project and to put their best people on it, and that means not do the other projects but to focus on one, complete it, test it, put it in the field, learn from it, use it as a training vehicle for their own people. That would take longer to do but at a slower pace. While they are doing that, I would add, they could be finishing the standards, both the interface standards and the security standards, to make sure that a system would be able to communicate. And I think at this point that is probably the best way to go to allow you to move forward and use as much as you can of the current expenditures and effort to come up with a system.

Chairman JOHNSON. Thank you. Let me recognize Mr. Portman. Mr. PORTMAN. I thank the Chair, and I have just a few follow-up questions of a general nature.

I am hearing in your testimony a little different emphasis than I see in the summary of the report.

Mr. CLAGETT. Oh, OK.

Mr. PORTMAN. It seems to me the report, indeed, does believe there are a number of deficiencies, and one, the CIO having been hired I guess is something that has been addressed, although from your conversation earlier I am not convinced that you think that the background and expertise is there, without getting into the individual person. But I sense from the report that you all believe that there is a need for what you call an ongoing mechanism to interact between the Secretary and this project generally and with the technical community, and you believe that there can be some improvements in management and so on. What I am hearing from you, though, is that perhaps it would have been best at the outset to have contracted this project out in total, much as we do in other areas of the government—environmental cleanup would be one that comes to mind, where there is technical expertise required and the government simply can't afford to keep that kind of expertise in the civil service; therefore, it is outsourced.

Is that a fair summary?

Mr. CLAGETT. That is a correct reading, Mr. Portman, and I should probably emphasize that last bit about contracting out was my opinion. It was not something that the committee addressed. It is my conclusion thinking about this thing after going through all that.

We have been recommending a strong person. In fact, we had recommended from the beginning that either the Deputy Commissioner, current Deputy Commissioner, be the person responsible because that person has enough clout to get the job done, or to have someone at that level do the job, beyond the CIO.

It took several years for that to begin. In the meantime, of course, during all that time, the CIO had the development responsibility. So when the former CIO retired, we had been saying you

need to have more expertise.

That was our solution during all of this time, and it certainly is still necessary to make sure that you get the maximum benefit from the funds that have been expended. However, as I said, I have now myself come to the conclusion that starting a new one, that

is not the way to go.

Mr. PORTMAN. Taking off your National Research Council hat, though, for a moment and just speaking in your individual capacity, given where we are in the process, would you now recommend that the Service, indeed, look at the possibility of contracting out some of these specific projects? I think in your testimony you mentioned the ICP as an example that could be, in a sense, showcased as one that could be successful if it was focused on. Or would you recommend that the Service continue to focus on internal expertise and capability to do that?

Mr. CLAGETT. I think it is pretty late to start changing, and ICP is largely done in-house. DPS, for example, is done essentially out-

side. That is the document reading, digitizing system.

So what we were suggesting was one that was independent of which system they pick, but that they pick one and focus on it. And we were also recommending one that is being done in-house in order to enhance, build on their own internal expertise at this time. And I still think that is probably the best way.

If there are units that are not now already well underway either inside or outside, I believe they would be better off done outside with a contractor. But one of the problems you see is that it was

not—I was struck by the earlier testimony between the Chairman and the GAO that IRS has some very good examples of achievements in individual developments, and that is so. What they haven't done well in my opinion and the Committee's is with a very, very large system like this, they started developing all of them at once. And they did so without setting the standards and the architecture first.

But they do have a lot of capable people inside, and our suggestion was that they pick an important project and put their best people on it and use that as an internal learning and training mechanism for the next project rather than trying to do all these on such a broad front at the same time. In other words, they have stretched all their people and I believe some of the outside contrac-

tors quite thin by doing it that way.

Mr. Portman. All right. That is very helpful. Again, without trying to paraphrase what you are saying, but your recommendation then would be to focus on specific projects to the extent those projects are already being undertaken internally and have made some progress, to continue along that path, develop the expertise internally; projects that are not already inside projects, to consider aggressive outsourcing or outside contractors for those; and all along to stress the need for systems architecture and standards first and then filling in the design logically which would follow.

Mr. CLAGETT. Yes.

Mr. PORTMAN. And security is your other primary issue you feel has not been handled well.

Mr. CLAGETT. We are very concerned about that, because if they don't set enough detailed standards, then as I said, since security in information systems is not something that can be a stand-alone package, it has got to be something that works at both ends, as I am sure you know. And that means you have got to have standards so that all of the designers of the new systems design their security systems to the same standards so that they work.

Mr. Portman. Well, thank you. As the Chair said, there is an appropriations issue here, and there are some interesting ways in which your testimony I think could give direction to the Agency as it looks at its appropriations challenge. Because if you can focus on some doable projects and see some success, I think then you have more likelihood of having—not those of us on this panel, but those of us who control the purse strings being more likely to be understanding and to want to support it. So I thank you for testifying.

Mr. CLAGETT. I must just in passing say I have personally tried for some time to convince the IRS to do that just because I said in industry a chief executive officer with such a project certainly wouldn't sit still for 4 or 5 years without seeing some end result, something completed and implemented. And wouldn't it be better for you to do the same, both for internal and all of your oversight people? That is not the way in which they approached it.

Mr. PORTMAN. Thank you.

Chairman JOHNSON. Thank you very much, Mr. Clagett. We will get back to you and see if there isn't some very specific assistance we can provide in this period, because it is an important moment.

Mr. CLAGETT. OK. I need to remind you, though, that we had a contract, as you know, with IRS, NRC did. That has expired. That

report that you have is our last one. The committee is all volunteers, and so I would say—I will speak personally. The only reward you get after spending all those years learning about it and giving advice is if somebody listens to the advice.

Chairman JOHNSON. Right.

Mr. CLAGETT. That is really the satisfaction. So I am certainly willing to do so.

Chairman JOHNSON. Well, thank you. I appreciate that. Why is

the contract expired?

Mr. CLAGETT. Why? Well, remember, this was the IRS' contract. They had a specified period of time. It was originally 2 years to look over TSM and make recommendations as to whether or not they were doing it right. They extended that for 2 years because the process and the project was continuing to go.

I will have to tell you that after 5 years, the committee, and that includes the chairman, was pretty well tapped out in coming down here making recommendations and not seeing a lot happen. And so

most of us were not willing to go ahead.

But I think the contractual arrangement with the National Research Council was one that had to be a specified time and a specified number of reports.

Chairman JOHNSON. Thank you.

Mr. CLAGETT. Yes.

Chairman JOHNSON. Thank you very much.

Let me call forward Joseph Lane on behalf of the National Association of Enrolled Agents. Sorry you had to wait so long, Mr. Lane.

You may proceed, Mr. Lane. Thank you for joining us this afternoon. We appreciate your perspective on these issues.

STATEMENT OF JOSEPH F. LANE, ENROLLED AGENT, NATIONAL ASSOCIATION OF ENROLLED AGENTS

Mr. Lane. Thank you. We appreciate the opportunity to come back before the Committee and share some of the insights that our members have about the budget situation with IRS and also the current filing season.

We have prepared some written testimony, and I would request that the Committee accept that. I would be happy to just highlight some of the written testimony and then be willing to take questions

from Members, if that meets with your approval.

We attempted to get a lot of input for this session today by going out with an e-mail poll of our members. We received scores of comments from members all around the country, so we are pretty confident in the positions we are taking as an organization with respect to the overall impressions that our members have of the IRS current filing season.

We also tried to take into consideration the average taxpayer that is going to be dealing with IRS, particularly in addressing this budget situation. As we heard this morning from the Commissioner, and we reviewed her written testimony, the budget cutbacks that were necessitated by the financial situation the Service finds itself in resulted in a lot of taxpayer service reductions. We have had an unprecedented report of the increase in the number of taxpayers who are coming to our members asking them for forms because they can't get them elsewhere.

Now, we applaud the Service's efforts this year to make forms available through CD–ROM and through the Internet. I understand that some 25,000 forms a day are being downloaded. But not everybody has a computer, and one of the concerns we have is the reductions in the taxpayer service forms distribution at the local level, the closure of some of these offices, the movement of some of the personnel from what were smaller rural offices into major centers has really necessitated a search and destroy mission on the part of some taxpayers just to be able to comply with their tax filing requirements. We have some problems with that.

I think one of the things we enjoy in this country is a very high compliance rate. Part of the reason we do that is because the American taxpayers are willing to go ahead and go through this self-assessment process. Part of the cost of that system ought to be providing them access to information to allow them to meet those responsibilities without going to too much trouble on their own and

also making it easy for them to file.

Now, the Service has made some major steps in the last couple of years in making it easier to get online to get information. Their new Web site is a vast improvement over their prior FedWorld site. The information they have now made available to people who have their own tax software programs and computers to file by modem, we applaud that. But the average person does not have a computer. The average person does not have access to an Internet account. The average person probably does not have a CD-ROM hooked into their computer, if they have a computer. And that person can't get service.

When we are looking at a telephone system in taxpayer service that answers 35 percent of the calls that come in, that is a problem. I dare say if I only answered 35 percent of the phone calls I had, I wouldn't be in business very long. I would submit to the Members if you only answered 35 percent of the calls that came to your office, you wouldn't be elected next time.

So there is a concern that that level of service needs to be addressed because you cannot have taxpayers trying to get in repeatedly, because I think eventually it affects voluntary compliance.

This light is—

Chairman JOHNSON. It is just a warning. When it gets red, you will have had 5 minutes. You don't have to stop immediately, but it is to give us all some indication.

Mr. LANE. OK. So we are concerned. We believe that part of a well-designed taxpayer service component within the Service is a necessary component for the voluntary compliance system. People have to be able to access the system, get information to fulfill their

requirements.

I think also in hearing some of the testimony today, the Service obviously is focusing on getting the tax returns they get processed, depositing the checks that they get, and having some degree of control over compliance. So what they have had to do in terms of their allocation of resources is focus on the money that is owed and the processing of the tax returns that come in the door. That makes sense. But somewhere along the line, the short end of the stick has been given to the taxpayer service function, and that has really had a dramatic impact on the average taxpayer out in the street. So I

would urge you on the 1997 budget to take a look at the allocations within that budget, what is happening in the taxpayer service area in terms of making it easier for taxpayers to access the service and

increase the quality.

With respect to the current filing season, I have to tell you that there is a vast improvement this year over the prior year. We have many fewer complaints from our Members and from taxpayers in general about the quality of the processing within the Service. I think the revenue initiative adjustments they made this year are clearly working. They are not delaying unnecessarily tax returns and refunds that were due to people that had legitimate filings. And I have to report that the problem resolution officers that we have talked to around the country in preparation for this testimony have all reported a much, much lower level of taxpayer complaints flowing into their offices.

So, in general, given the situation that the Service found itself in this year with the budget restrictions, the bad weather in the East, and the possibility of a tax law change right up to the last minute, I think they deserve a round of applause for the job they are doing in this current filing season. I think the information we

got from GAO indicates that it is running fairly smoothly.

In closing, I would like to add one important thing that we have noticed, and that is, some of the cutbacks that the Service has had to do because of the budget situation have affected things like continuing professional education for their employees. Now, this creates a problem for taxpayers because we are in a period of change right now, both in the examination function and the collection function.

As you will recall from the hearings last year, we had exam taking a whole new direction with respect to the financial status or economic reality auditing. We have a new set of collection standards that were implemented last September 1 with respect to national and local standards. And we have a lot of discrepancies being reported by our members in the way that these new standards are being applied across the Nation by revenue officers. One of our concerns is if there is a cutback in continuing professional education training, we are going to have this inconsistency cropping up more and more.

Another part of the problem that we are concerned about with the budget reductions is the district directors have had to curtail their communications with the practitioner community. Many of them eliminated their local newsletter. That newsletter served as a vehicle to communicate procedural changes within the Service that helped tax practitioners advise their clients.

Those types of cuts, while they are understandable given the budget situation, are very shortsighted, because eventually it catches up with the system by having people doing stuff that is out of date, not being aware of new procedures, not being aware of

changes that the Service has implemented.

The overall impression we have of the budget problems within the Service is there is a tremendous morale problem at the lower levels of the Service. This is driven by several factors. There are rumors throughout the organization that because they are underbudgeted something in the neighborhood of 8,000 full-time equivalents this year, the average employee will be asked to take anywhere from 8 to 11 days furlough time this year without pay. There are rumors in almost every office that there is going to be a RIF, a reduction in force.

When you talk to people in the offices that are not in major cities, there is discussion about the task force that is looking at the whole question of IRS rents, justifying any area office that is under 10,000 square feet. If implemented, that closes a lot of small offices serving rural communities. Our members are also concerned that we are being asked to go to Sacramento or Chicago to deal with an appeal that might have been closed locally 2 years ago, but that office is gone now.

There are also some real concerns about the reorganization that IRS is going through. The number of districts by October 1 this year will go from 63 to 33. They have eliminated 30 districts. Many of you are serving from congressional districts that now have been combined with other States, and that is of concern to our members

and to taxpayers in those areas.

We are also very concerned about employee morale, so much so that we would urge the Committee to have GAO conduct a review of IRS employee morale. In any tax administration system, tax collectors and tax enforcers like revenue officers, revenue agents, and tax auditors, are not exactly the most popular people on the block. Everybody understands that. That is the nature of the business they are in. But you need to keep them happy to a certain degree with their working environment, because the last thing you need is 30,000 or 40,000 disgruntled tax enforcement people roaming around the country. What happens is that their frustrations get taken out on the taxpayers they get assigned to them. That is a major concern of ours and obviously of the Committee as I understand that this Committee is considering the possibility of holding some hearings later this year on the whole IRS collection and enforcement area.

We are hearing more and more horror stories coming out of the field about specific cases where we have problems with employees not following procedures, and that to me is indicative of a morale problem. IRS had a serious number of resignations and retirements this year, partly as a result of the rumors with respect to the changes in the Service and partly as a result of reorganizations, and that has not contributed to making the IRS a happy place to work within. That is being reflected now in the cases we are seeing come forward to our National Government Relations Committee for action. So we would urge you to take a look at that whole area. Maybe it is appropriate for GAO to conduct a review of that.

One last thing, in the TSM area, I am very concerned both as a tax practitioner and a taxpayer about this question of the IRS technical capability. As you know, I am from Menlo Park, California. That is the heart of Silicon Valley. I have a fair number of Silicon Valley entrepreneurs who are clients of mine. There is a lot of discussion about the impact that we are going to have in terms of our voluntary compliance system when we see more and more electronic commerce happening on the Internet. We have electronic cash. We have virtual banks, and we have encryption technology that is getting better and better. The concern that I have as a tax-

payer is we have a potential disaster brewing out there for our voluntary compliance system if we have an environment where transactions cannot be traced. And we are getting very close to the day when that is going to be a reality.

The Service needs to have as much technological assistance as it can get at this time, perhaps through contracting, as the gentleman that just appeared before me suggested. They need to buy the expertise. Quite frankly, the CIO position that they are offering something at SES level 3 or \$108,000 or \$112,000 a year, would in private industry, be a \$400,000 or \$500,000 job with pretty attractive stock options. In addition, if that person guided a successful program they would be in line for a couple of million dollars in compensation. It is way beyond the reach of the government.

We are concerned about asking the government to race in an Indianapolis 500 in a 1936 Plymouth against Formula One cars. We have the potential for a real problem for the voluntary compliance system. I think this fuels a lot of taxpayer discomfort with the current tax system. It fuels the whole discussion about why we need a flat tax or should we throw the whole system out the window. Average taxpayers don't mind paying their taxes if they feel that they are paying their fair share and no more, and everyone else is paying their fair share as well. If there is a widespread perception that there are significant unreported income transactions happening on the Internet, which I think is a good possibility, and that they are virtually untraceable because of this encryption technology, you are going to see a major tax revolt in this country. We are very concerned about that as tax practitioners and as taxpayers.

[The prepared statement follows:]

STATEMENT OF JOSEPH F. LANE, EA ON BEHALF OF THE NATIONAL ASSOCIATION OF ENROLLED AGENTS

Madam Chair, Members of the Subcommittee, my name is Joseph F. Lane. I am an Enrolled Agent in private practice in Menlo Park, California. I thank you for your invitation to testify on behalf of the National Association of Enrolled Agents regarding the proposed FY 1997 IRS Budget and the status of the current tax filing season.

I am testifying today on behalf of the more than 9,000 members of the National Association of Enrolled Agents (NAEA). As the members of the Subcommittee well know, Enrolled Agents are the only tax professionals possessing a Federal license to represent taxpayers before the Internal Revenue Service. Our members represent more than four million (4,000,000) individual and small business taxpayers annually. NAEA is especially appreciative of the interest this Subcommittee has taken in the matter of Internal Revenue Service practices and procedures and their impact on taxpayers. We pledge our support to assist the Subcommittee in the future on issues which affect the general taxpaying public.

The Proposed FY 1997 Budget

As small business owners, the members of NAEA fully support the concept that the Federal government should be as careful and diligent in spending the revenues it receives in taxes as taxpayers are in earning those revenues. It is important to all taxpayers to be confident in the ability of the government to adequately account for the expenditures it makes on behalf of taxpayers. It is also important for taxpayers to recognize that certain functions of government need to be adequately funded in order to be effective. We believe that with respect to this last point, the FY 1997 IRS budget needs to be considered in light of the impact of the FY 1996 budget cuts on IRS operations.

During the course of our preparation of today's testimony, we conducted an e-mail poll of our members to solicit their feedback on the issues being examined by the Committee. We received scores of messages from members all over the country and have incorporated many of their comments throughout our prepared statement.

In addressing our comments today, we have tried to take into account the realities of tax compliance for all taxpayers, not only those who are the clients of our members. We point this out because we think the Congress needs to be aware of the effect reductions in Taxpayer Service staffing and availability have had on the general taxpaying public. When the Service has to curtail the availability of telephone and walk-in assistance to taxpayers, the taxpayers that are directly affected are those with the fewest alternative resources to turn to for information. Our members' clients will get their questions answered and their tax returns prepared because they have sought out competent professional advice and have the resources to pay for that advice. About 50% of the taxpayers filing returns in 1996 will seek professional assistance.

Who will service the rest of the taxpayers who need questions resolved in their effort to comply with the law? There are many volunteer organizations, such as senior citizen community centers, college accounting organizations, and other entities which provide free or low-cost taxpayer assistance to certain constituencies. The IRS' own Volunteers In Tax Administration (VITA) program provides a structure and support system for several of these volunteer efforts. Many of our own members volunteer their time as well in these community efforts. However, all of these efforts put together cannot replace the IRS' Taxpayer Service function.

We believe a well-funded and well-staffed Taxpayer Service organization is vital to insure the viability of our voluntary compliance system. We have one of the most complex tax systems in the industrial world. At the same time, we enjoy one of the highest levels of voluntary compliance in the world. The cost of securing this compliance is providing taxpayers with answers to their legitimate questions and assistance in meeting their filing responsibilities. To fail to provide this support is to risk further decline in compliance levels. Everyone involved in tax administration understands that the most expensive way to secure compliance is one-onone enforcement. The most efficient and cost-effective way to secure high compliance levels is to provide readily accessible information in the most inexpensive way to the widest number of taxpayers, enabling them to comply with their tax filing and paying obligations.

The current budget provides for an inadequate level of service on the Taxpayer Service telephone system. The Service itself estimated that it will be able to answer only 35% of the calls taxpayers make this year. Our members have reported an unprecedented increase in the number of requests they receive in their offices from taxpayers who are not their clients but who are seeking tax forms. These are taxpayers who are trying to comply with the law! They should not have to go on a search and rescue mission to locate forms!

Many of our members report that even the special telephone lines IRS established for practitioners have been going unanswered for up to 30 minutes at a time. One of our members reported that he has not been able to get through to the Atlanta Service Center yet this year! The inability of the practitioner to access the Service through the designated "hottine" merely adds additional volume to the already overloaded public lines.

Other members have told us about attempts to secure new Federal Employer Identification Numbers (EINs) from Service Centers. This used to be taken care of in a phone call but is now requiring weeks because the Service had to reassign the employees to other tasks. If taxpayers are unable to secure EINs in timely fashion, there will be delays in filing of returns or returns will be filed without EINs resulting in even greater backlogs for the IRS.

Due to cut-backs in Taxpayer Service staffing, we have heard complaints about the unavailability of Examination employees to finish audits they began months ago because they are assigned to handle walk-in service. While delaying an audit may seem to some to be a relief, to those taxpayers with audit deficiencies these delays add considerable additional interest charges, not to mention additional professional fees.

The budget reductions have also complicated the processing of other than Taxpayer Service workloads. We have heard complaints from practitioners who now have to travel to cities farther away than before due to IRS office closings or personnel reassignments. The span of control of some Group Managers has been increased substantially, in one case from 11 employees to over 30 located in two posts of duty. This manager spends hours a day shuttling between the posts.

Another area of major concern to us is the announcement made at liaison meetings with practitioner organizations that the Service cannot afford to hold Continuing Professional Education classes this year for employees. This has already caused problems and inconsistencies in how Revenue Officers are applying the new National/Local standards in Collection Division cases.

As another example, we have worked for years to urge the Service to develop a system of Appeals for Collection cases to enable taxpayers to get enforcement actions reviewed prior to implementation. Finally, the Service agreed and the new system is to be implemented next week. We are very concerned with the ability of Appeals to shoulder new work reviewing Collection decisions on liens, levies and seizures when their traditional workload is starting to rise due to attrition caused by senior staff retirements and resignations.

It is reported that the IRS will not be printing Publications 17 and 334 next year as a budget saving measure. Package X may be dropped as well. These are critical publications for many taxpayers who do their own returns, for the many volunteer tax organizations that service their communities, for adult education programs that offer tax and small business courses for individuals who contemplate starting their own enterprises, and for many smaller tax preparation firms which cannot afford extensive tax libraries. To eliminate these publications will prove to be a false economy for certain.

Also due to budget constraints, many district directors have stopped publishing their practitioner newsletters. In California alone, we know of five district directors who have shelved their newsletters. These publications are invaluable, particularly during filing season, to help practitioners keep up with changes in practice and procedure within the IRS. Again, practitioner groups are working with the National Office to fill the gaps, but these efforts do not replace consistent outreach which the district directors have been successfully using in the past.

One of the consequences of the FY 1996 Budget reductions that causes us a great deal of concern is the impact on IRS morale. We understand, perhaps more than most taxpayers because we deal with them everyday in representing our clients, how difficult a job the Service employees have to perform. There has been a decidedly negative impact on employee morale in the past year. The prospect of unpaid leave days being mandated has had a discouraging effect on employees. Rumors of a Reduction in Force or RIF are rampant in every office.

Our members have reported that certain enforcement employees have started to exhibit an attitude of callousness to the plight of taxpayers far in excess of their usual indifference. No one who works for IRS ever expects to be courted at cocktail parties but they do have the right to expect that those they work for appreciate the difficulty of their positions and respect them for the tough job they perform. In the current political climate, it is very effective to launch ad hominem attacks against the IRS, government employees, and the tax system. We would hope that constructive criticism would spur an honest debate about the kind of tax system we should have in this country. We are concerned, however, that these gratuitous attacks will only cause further decline in the morale of employees.

As you know, there have been a great many retirements from the Service this past year. In fact, during Calendar Year 1995, 45 senior executives retired. We have been told by some retirees that they left because they no longer felt the organization had the Congressional support it needed to fulfill its mission. This attitude concerns us because our current tax administration system depends on having competent, well-intentioned people on both sides of the table. The ability of the Service to continue to attract capable, dedicated employees is of primary importance for a continued well-balanced tax administration system. The system as currently constituted cannot support a dramatic increase in cases that have to be referred to Problem Resolution or forwarded on to Appeals simply because disgruntled employees start taking their frustrations out on taxpayers. It is difficult enough for some taxpayers to deal with the Service under normal conditions. It is impossible to predict what Kafkaesque nightmare could result if the Service were not able to attract and retain the usually high calibre employees they have had in the past. With the staffing cutbacks, downsizing and reorganizations of late, we are fearful that they may be on the verge of such a situation.

We suggest it may be an appropriate time for the Congress to instruct the GAO to conduct an in-depth employee attitude survey within the Service. Once the attitudes of those expected to do the difficult job of collecting society's bills is assessed, Congress may be in a better position to deliberate changes that affect those employees. We recognize that this topic is not one the committee is addressing in today's hearings but we urge the committee to consider this suggestion and offer our cooperation in any effort undertaken.

The 1995 Tax Return Filing Season

We believe the Service is to be commended for the efforts made this year to expand the vehicles available for taxpayers to secure assistance with their tax filing requirements without a concomitant increase in cost to the Service. The expansion of electronic filing capacity to individuals with their own tax software and computers who elect to file via modem is a welcome development. The new IRS home page on the World Wide Web is orders of magnitude better than the old FedWorld site. The availability of tax forms for downloading has proved very beneficial to taxpayers with computer access. The forms themselves are much more user friendly including the 1040, with color yet! The newly revised Publication 334, Tax Guide for Small Business, and new Publication 583, Starting a Small Business, have won the acclaim of practitioners and small business taxpayers alike. The expansion of the TeleTax program has yielded very positive support from taxpayers in all walks of life. The study group the Service has convened to eliminate unnecessary notices will cut down on needless taxpayer calls to Service telephone sites and free up scarce resources for deployment on more important tasks. Our discussions with the upper management of the Service lead us to conclude that the effort to reassess the traditional ways of interacting with taxpayers will continue to receive significant emphasis and we anticipate more improvements in the future.

Our members report they have encountered far fewer problems this year compared to last year in the area of refund processing and electronic filing. It would appear that the changes the Service

announced in its revenue protection strategy have indeed had the desired effect of involving fewer taxpayer delays in processing. The Problem Resolution officers with whom we have spoken report far fewer problems this year.

We were advised of some problems with the processing of TeleTax returns earlier in the season but now believe those difficulties have been addressed and resolved.

All in all, our members have reported that the current filing season is proceeding rather smoothly from a processing standpoint. When one considers the difficulties the Service confronted this year -- bad weather in the East, possible tax law changes, and significant budget reductions -- it deserves a round of applause for the relative ease of the current filing season.

Summary

We thank the Committee for the opportunity to appear before you today and provide our views on these vital topics. We remain committed to assist in any additional matter where the general taxpaying public has an interest. We will be happy to respond to questions from the Committee.

Chairman JOHNSON. Thank you, Mr. Lane. I appreciate your testimony, and I appreciated your enumeration at the end of it in more detail of your comments about the things they have accomplished and the ways in which the current filing system is going better than past filing systems. And I thought your comment about the difference between what the Service offers to those with computers and modems and what it offers to others was very helpful. Certainly it offers a nice small business opportunity for our local libraries and some of our community-based organizations that have good computer capability. And that may be one area that we want to pursue to assure that all of our libraries are properly equipped in this era in which I think IRS service delivery is going to go increasingly toward use of tools that computers offer rather than individual people, as important as that is.

You do also make some very strong statements about morale—I think that really is a problem—and about the callousness that you find in some of the IRS people, in excess of anything you have ever seen. I do think the IRS people, as most Federal employees have, have taken some really unfair blows through the budget process. It is really unfortunate that much of the discussion about tax reform also involves maligning very good, hard-working, competent public employees who are on the whole doing a pretty good job with

limited resources.

I would mention to you that the IRS has just come out with new guidelines governing the use of the economic reality audits or life-style audits. I made some very strong statements in the Full Committee hearing when we worked on the Taxpayer Bill of Rights, and the IRS has chosen to include my remarks in the distribution with their manual. So people will see how terribly important it is to not only elected officials but also the general public and folks like you, that these audits be used when there is a cause or a reason or an indication and not randomly or erratically. And that is important, especially in an era when there is dissatisfaction, much of it legitimate, in not letting that spill over onto the taxpayers.

Unfortunately, I have to leave. I appreciate your testimony, and when we come back to that hearing in the future, we may look to

you for further input at that time.

Mr. LANE. We would be happy to provide it.

Chairman JOHNSON. I am going to recognize Mr. Hancock, and if he will take over the gavel, he and Mr. Portman may have questions.

Mr. Lane. Thank you again for the invitation.

Mr. HANCOCK. I have just got a couple of questions about your statement that transactions over the Internet can't be traced.

Mr. LANE. That is right.

Mr. HANCOCK. I don't understand how that works. I mean, if you put something on the Internet, almost anybody can pick it up if the information is there.

Mr. Lane. Well, the encryption, as I understand it—I am not a software engineer, but I am fairly familiar with this information. But as I understand it, the encryption technology is so far advanced now that you are going to see, probably within the next 2 or 3 months, a major jump in the number of transactions on the Internet that are encrypted so they are anonymous. Basically there

are electronic cash transactions happening where you could have funds transferred in virtual banks, so the bank does not exist physically anyplace except in one location and the rest of it is online.

Mr. HANCOCK. Well, let me make this comment, Mr. Lane. For everything man can invent, another man can figure out how to circumvent, because you are not going to come up with anything that cannot be counteracted. The fact remains that when people get to the point, as you mentioned earlier, that they feel they are overtaxed, they are going to start trying to figure out some way to keep from paying it.

Mr. LANE. That is right.

Mr. HANCOCK. And nobody really wants to take the chances on going to jail and what have you. And, boy, you are opening the door.

Now, there is only one solution, and that is to get the tax structure back to where people feel like they are paying their fair share.

Mr. LANE. Well, I can't disagree with you on that.

Mr. HANCOCK. OK. I think a good book to read would be Adams' "The Good and Evil of Taxation," which maybe you have already read. This is the history of society as to what has happened when the citizens start feeling that they have been overtaxed.

I would also like to ask you this question. You mentioned being able to figure out your income tax on CD-ROM. Why should it even be necessary for somebody to have a CD-ROM to fill out their income tax return?

Mr. Lane. Well, I think the point was that with a CD-ROM disk, you can put all the tax forms that are available on one disk, and make those available in the library. If somebody needs a form, they can stop by and pick them up. That is a very cost-effective way of distributing forms.

Mr. HANCOCK. Well, it is cost effective, but why have a tax structure set up that way in the first place? And let me ask you this question. I understand, and I think I know what the answer is, but how many of these forms are merely statistical informational forms that actually it costs the taxpayer and the government more money to keep the records for statistical purposes than it does in realizing revenue?

Mr. LANE. Well, I don't know—

Mr. Hancock. Now, that is conjecture, you know. I mean, you have got to guess at it. That is one part of the question. The other part of the question is: I understand that about 70 percent of the income tax returns are filed on the short form, so, therefore, you are only concerned about the 30 percent that use the long forms. My question is: How many of the people using those short forms do it for two reasons. One, they don't want to do the paperwork, they don't know how, or they don't understand the law. Therefore, they just go ahead and pay their taxes, and do not keep track of their deductions and fill out the long form. Two, how many people use the short form because they fear the IRS and they know that they don't have anything to fear as long as they just go on ahead and send in their W-2 and forget about it? How many people do that and actually pay more taxes than they really would owe if, in fact, they did go on ahead and fill out the long forms?

Mr. Lane. Well, to answer part of your question, I believe there is something in the neighborhood of about 60 million 1040A, 1040EZ type forms filed. I don't have the exact number. I think it is in the neighborhood of 60 million.

To the extent that we could establish what portion of that tax was overpaid because people didn't take deductions they were entitled to, I don't know of any study anywhere that took a look at

that.

Mr. HANCOCK. Well, I am asking you. Mr. LANE. I see your point, though.

Mr. HANCOCK. Have you ever had anybody come to you about filling out their tax return and say, hey, I don't want to take these deductions and take a chance. I would just as soon go on ahead and pay more than I owe. Have you ever had people tell you that?

Mr. Lane. I have heard that from people, people that had prior audits from IRS, for example, and didn't want to deal with them

again on it. Yes, I have had that.

Mr. HANCOCK. Sure.

Mr. Lane. Let me tell you, about half the taxpayers in the country seek professional assistance to get their tax returns done every year. So about half the returns are preparer prepared, and the

other half are sent in by taxpayers.

Mr. HANCOCK. But even with a professional tax preparer's help, how many times have you had people come in and say, look, I realize that I can save maybe a couple hundred bucks, but it just isn't worth it. I would rather just go on ahead, send the government the extra \$200, rather than take a chance that I might get audited or that they might question it, you know, if I get this refund?

Mr. Lane. Well, I could tell you there are several areas where that absolutely does happen. One of them is anybody that has a business that has a home office. Until there is some material change done in the way this home office stuff is administered, you are going to continue to see taxpayers say, no, I don't want to start a fight with them, just leave that deduction off my return, even though they are entitled to it.

Mr. Hancock. Well, they do it with automobile expenses, too.

Mr. LANE. They do it with car expenses, another area. I don't have the information to answer what percentage of revenue is over-collected.

Mr. HANCOCK. I understand that there is no statistical information

Mr. LANE. But it does happen.

Mr. HANCOCK. But there are a lot of people who do it. You know, in my position as a Member of Congress, I run into a lot of people. And I am not out in the country clubs on weekends. I am out at the truck stops, and I get a lot of this type of information: Look, I don't really feel like I owe the money, but I am just going to go ahead and do it. And I still maintain computers are great up to a point, but without computers there is no way we could have an income tax law like we have got.

Mr. Lane. There is no question about that. There is a certain amount of mythology that surrounds IRS. Some people are doing what you are talking about because they believe they can stay underneath the IRS radar. They may have income that they are not

disclosing, or they just don't want any hassles with IRS. They believe that by filing a short form you don't get audited. There is a

lot of mythology about that.

I can't tell you what percentage of clients that come to me every year to get their tax return done because they have never been audited as long as I have been doing their tax return. Well, you know, they don't realize that only 1 percent of the taxpayers get audited. That is like saying as long as this mike has been here, I haven't been audited, so this mike is my good luck piece.

Mr. Hancock. Well, let me ask you a hypothetical, probably facetious question. What would happen if a group got together, including some Members of Congress and IRS, and sat back and said how could we design the tax law to where we can get the revenues of government that we need where people wouldn't have to use computers, and analyze it from that standpoint? I wonder how we would change it. I wonder if we could forget about the government's problem of Internal Revenue agents being trained and then having the private sector hire them.

Mr. Lane. I can answer it this way. I have been teaching tax professionals for about 10 years now, and I facetiously have said on many occasions that it ought to be a felony for Members of Congress to get professional assistance with doing their own tax returns, and it ought to be a felony for them to use a computer to

do so. OK?

Now, I have said that kiddingly, but I could tell you this: If computers were taken out of the equation, I wouldn't stay in this business any longer. It is too frustrating to try and do these things by hand.

Mr. HANCOCK. The law would have to be changed; correct?

Mr. LANE. You would have to change it.

Mr. HANCOCK. You know, I would even contribute to an organization and send them some money if somebody would sit back and just visualize a tax system without computers. How could we design a tax law that the average Ph.D. without a computer could fill out? You know, we might come up with something even better. You know, that is not a bad idea at all, the more I think about it. We might come up with something that would beat Bill Archer's sales tax and Dick Armey's flat tax. Gosh knows we wouldn't have to worry about industry, hiring all the Internal Revenue agents after they are trained, because this thing would be so simple you wouldn't have to have that much training.

I think we ought to talk about that, Rob.

Mr. Lane. Well, one of the encouraging things about this tax debate we are having now, hopefully—I mean, in a perfect environment—it will lead to a situation where there will be an honest debate about what kind of tax system we ought to have in this country.

Mr. HANCOCK. But the fact remains that with all these forms and everything, you have got all kinds of inaccurate statistical information because by the time you get it in the computer it is 5 years old, anyway. By the time you come up with the figures from the tax return, they don't have any meaning. They won't know for 5 years what the 1995 results are, actually.

Mr. LANE. Well, with respect to TCMP, you are right.

Mr. HANCOCK. Right.

Mr. Lane. Yes.

Mr. HANCOCK. Thank you. I am going to think about that a little bit. We just might put together something on that order.

Mr. PORTMAN. I think I just figured out what Mel is going to be

doing next year.

As you may know, Mr. Lane, Mr. Hancock has a long history in the tax area, and he is retiring from Congress. But it sounds like he is going to be busy. You will probably be testifying before us next year at this time, Mel.

Mr. Lane. They could probably arrange a desk for you at the

Cato Institute down the street.

Mr. PORTMAN. He is even more radical than they are.

Mr. HANCOCK. Well, I just don't think—pardon me, Rob. I just don't think that filling out your income return ought to drive a person to drink. I mean, they ought to be able to do it without getting so frustrated that they have to go get a shot of bourbon after they have filled it out.

Thank you.

Mr. PORTMAN. I am going to miss him.

Mr. Lane, first of all, thanks for coming back again. It is always a pleasure to have you before the Subcommittee and Committee.

Mr. LANE. My pleasure.

Mr. PORTMAN. You worked for the Service at one point, didn't you?

Mr. LANE. Yes, I did.

Mr. PORTMAN. Yes, as I recall, he is one of those guys that got

hired away. Where is Mel?

I just had a couple of quick questions. First of all, you should give yourself more credit for not having your clients audited. You might have had something to do with it. But back home, I have gotten a number of letters from people about date stamping, and this is in connection with the budget cuts you talked about. I just wondered if you had had that experience with some of your members, folks who are calling or writing and saying at our local office—this is in Cincinnati, Ohio—there used to be a clerk behind the counter, and you could take a return in and have it date stamped, which avoided having to send it by certified mail.

Had you heard that complaint raised from any of your members?

That the date stamp service has been eliminated?

Mr. LANE. It is happening in California right in an office near us. They used to have a person that would man that desk, and that desk is closed now. It is gone.

Mr. PORTMAN. Is it still closed?

Mr. LANE. Yes.

Mr. Portman. OK. I think, again, so much of the blame for the way our current system works resides up here because we are passing the laws and we are providing the budgets and, therefore, forcing the Agency to look for places to cut. But I think from what I understand about this particular problem, it doesn't make any sense to make that decision not to have date stamping because it actually will end up saving the Service money over the longer haul. It is an interesting way to wake people up as to the budget problem, because a lot of these professionals, many of your members,

I am sure, were shocked when they found out those desks were closed. And I wanted to check and see if that was also a problem elsewhere.

It is my understanding in Cincinnati that has been resolved, although I am not sure and will now look into it more.

You mentioned two things in your testimony. One is that the 1995 calendar year filing is going pretty well. In fact, I think you even say that it is going smoothly, rather smoothly from a processing standpoint. You also, though, then talk about, Mr. Lane, this attitude of callousness that is far in excess of the usual indifference. And I just wanted to touch on that briefly.

You mentioned a morale problem. You talked about the immediate budget cuts and the impact that might be having. You talked about the reorganization, the RIFs. I am in an area, as I suppose most if not all members are, where there has been reorganization, and I didn't oppose that. In fact, I was supportive of it with the idea that we could get some efficiencies out of the system and have more bang for the buck, in a sense. But to what do you attribute this callousness? Do you think it is a combination of all these factors? How would you pinpoint it?

Mr. Lane. I think it clearly is a reflection of employee frustration with the system and uncertainty about their job future, and to a certain degree, it is almost acting out. You can have a situation where there is no other way they can get back at the system, so the way they do it is make sure they follow the book right down the line or be unreasonable in the way that they are making demands on people. This is a very small minority of the employees there, but we see it on a national level because our members fax these situations on to us and say, can you get us some help on this?

It just seems to me the level of e-mail and telephone calls I am getting and the volume we are seeing in our government relations office here in Washington indicates an increase in the sort of unreasonable behavior on the part of some of these enforcement people. And it is a callousness. It is a disregard for the impact their actions have on the taxpayer.

Now, in some cases when we get into these things, the actions are warranted. In other cases, they are not warranted. If they are clearly not warranted, we have to go to upper management to get them to back off.

But my concern is I am trying to look at it in a macrosense. Every one of these individual cases on a case-by-case basis you can see some justification as to why the employee has taken that position. You can also see some justification why the taxpayer is taking the position. But on a macrolevel, when I look at the totality of the complaints that we are starting to see from members, it confirms feedback I am getting from friends of mine that are still within the Service and from employees that I am dealing with on a regular basis, which reflects that there is a real morale problem within the organization.

Now, you know, part of the problem in terms of any enforcement effort you are involved in is the insularity of thinking within the organization. Partly it is a function of reality. My dad was a police officer, a career police officer. You know, all of his friends tended to be other cops, and the reason for that was partly because they tended to work odd hours, so they had Tuesday afternoons off when everybody else was at work. But also part of it was this kind of usthem thing.

That is very true in the IRS. IRS people tend to socialize with other IRS people. I think you will see in any situation that an attitude, if it is a positive attitude, is reinforced by management coming down and saying, yes, you know, this is good behavior and it has got to be rewarded, and this is bad behavior. Everybody assumes when you go to work for IRS you are not going to be the belle of every cocktail party. That is just a given. It kills more conversations at cocktail parties when you are at someone's house and they say, Where do you work? And you say IRS. It is amazing how many people have to refresh their drink at that time. I think Mr. Hancock might have had a point about needing that bourbon. They just disappear.

So there is a situation in terms of morale within the organization, and right now because of the political season and because of all of this discussion we have had about the tax system, there are ad hominem attacks daily on IRS employees, on the tax system, and on the government in general. I think the problem with that is that if that leads to a constructive discussion about what kind of a tax system we ought to have in this country, that is fine. That is the purpose of democracy. If the only result is that you have a whole bunch of demoralized enforcement people running around with badges now and the only way they can take it out is on the people, that's bad.

Mr. PORTMAN. You have got the same bad system or a system that is comparably bad.

Mr. LANE. Yes.

Mr. PORTMAN. Well, I would agree with you. The irony of it is that the reason we have such a problem—and I think Mel and I would agree on this—is because of the laws that these people are asked to enforce. If it wasn't so darn complicated, if there weren't all these judgment calls to be made, 50 different results from 50 expert tax preparers, as Money Magazine told us last week, you wouldn't have the degree of frustration and the degree of morale problems.

Mr. LANE. That is right.

Mr. PORTMAN. But also, I think given our current system and given where we are, there are probably ways to improve it. And from what you have said, it sounds like part of that can come from leadership, from both elected officials and within the Agency, to try to improve that situation. You talked about the incentives you could put in. You talked about just providing leadership in the sense of saying, hey, it is not the agent's fault; this is a system that is bad; let's work as best we can within it. I think we probably all have some responsibility there.

But I would hope that, in fact, the discussion over the next year will include the fact that we are the people who are going to be responsible for cleaning up the system so that those agents can do their job better. I would also hope we will have fewer agents, frankly, because I think that is part of the consequence of a system that needs fewer judgment calls and less complexity.

Mr. Lane. I think one of the other things that could be driving this is the reorganization of IRS, which has eliminated 30 districts by consolidating districts, has taken the managerial oversight structure out of a lot of areas. What you have now is an agent who is responsible to a group manager who might be 500 miles away, who has a branch chief that, in the case of Hawaii, is 3,000 miles away in Seattle.

Mr. PORTMAN. Do you think the reorganization is a bad idea? How do you come down on it?

Mr. Lane. You know, that is a tough one. I can understand the Service's situation. They had basically an unchanged, 40-year-old organizational structure that was appropriate in a day when it took 12 hours to get to California in a prop jet and you didn't have fax machines and you didn't have teleconferencing. But on the other level——

Mr. PORTMAN. As I understand it, a lot of the RIFs would have occurred—not even RIFs, necessarily, but transfers at the middle management level, that it was part of the IRS catching up with the rest of the private sector to become a leaner operation.

Mr. Lane. What has happened, it has stripped out the management level in a lot of these small districts. So, for example, in Montana and Idaho and those places, you have the agents that are on the street and their supervisors, and that is it. There is nothing else above them. You have to go to another State to get a branch chief or a division chief involved. One of the frustrations to the practitioner community and to taxpayers in those locales is what is the chance of a branch chief getting over to Missoula every week where there used to be a branch chief sitting there?

So you had an appeal process that went up above, and that to a certain degree kept people in check. Now the concern, I know, in Senator Stevens' Committee the other day, there was quite an extensive discussion about what happened to the State of Alaska when they did away with the district director and sent him to Seattle. But we are reflecting that from our membership as well in those States that have been affected. People feel that they are not being supervised anymore, so they can go do what they want to do.

Mr. PORTMAN. Well, maybe that is something after a year or two we will have a better sense of, too, as that system begins to adjust to the new levels of leadership and management.

I thank you very much for coming again today, and I will now, Mr. Chairman, leave it up to you to finish this hearing.

Mr. LANE. Thank you.

Mr. HANCOCK. One final question. Have you ever heard anybody say I would be willing to pay more taxes if I didn't have to keep all these records and fill out these forms?

Mr. Lane. I have heard people say that they wished they had a simpler system. I have heard people say they would be willing to pay more if they knew everybody was paying their share. And I don't argue with you. You know, as a tax professional, I know some people on your Committee might think that we are dealing from self-interest. There is no one more in favor of tax simplification than the people that have to fill out these forms every year. Believe me.

I have a client who is the director of the Stanford linear accelerator unit out in Menlo Park, and we get laughing every year and talking about stuff and tax law changes. And I said to him, "Just imagine if you had to go to work January 1 every year and the laws of physics were repealed and you had to learn a whole new set of physics laws to go do your job." That is what we are dealing with.

You know, we have had 27 tax law changes in the last 29 years. Mr. HANCOCK. Do you think we need to change the laws a little bit to give you all some legal liability protection for making mistakes? You know, there are a bunch of CPAs getting sued now as a result of improperly completing tax returns due to Internal Revenue laws that nobody really understands.

Mr. LANE. Yes.

Mr. HANCOCK. So, really, you are assuming some liability when you fill out somebody's tax return.

Mr. Lane. That is a cost of doing business. You have got to commit yourself to maintaining a professional library to let you stay out of a lawsuit.

Mr. HANCOCK. Let's work on it. Thank you.

Mr. LANE. Thank you.

Mr. HANCOCK. This hearing is adjourned. Thank you.

Mr. LANE. Thank you very much.

[Whereupon, at 2 p.m., the hearing was adjourned.]

C

TAX DEBT COLLECTION ISSUES

HEARING

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT

COMMITTEE ON WAYS AND MEANS HOUSE OF REPRESENTATIVES

ONE HUNDRED FOURTH CONGRESS

SECOND SESSION

APRIL 25, 1996

Serial 104-65

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TAX DEBT COLLECTION ISSUES

THURSDAY, APRIL 25, 1996

House of Representatives, Committee on Ways and Means, Subcommittee on Oversight, Washington, DC.

The Subcommittee met, pursuant to notice, at 9:39 a.m., in room 1100, Longworth House Office Building, Hon. Nancy Johnson (Chairman of the Subcommittee) presiding.

[The advisory announcing the hearing follows:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

SUBCOMMITTEE ON OVERSIGHT

FOR IMMEDIATE RELEASE April 17, 1996 No. OV-12 CONTACT: (202)-225-7601

Johnson Announces Hearing on Tax Debt Collection Issues

Congresswoman Nancy L. Johnson (R-CT), Chairman of the Subcommittee on Oversight of the Committee on Ways and Means, today announced that the Subcommittee will hold a hearing to examine a number of tax debt collection issues, including: (1) the status of the Internal Revenue Service (IRS) accounts receivable inventory; (2) issues relating to the use of private collection agencies to collect delinquent Federal tax debts; (3) provisions in H.R. 2234, the "Debt Collection Improvement Act of 1995" relating to IRS levy authority; and (4) H.R. 757, relating to Federal tax refund offset authority for purposes of collecting delinquent State tax debts. The hearing will take place on Thursday, April 25, 1996, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 9:30 a.m.

In view of the limited time available to hear witnesses, oral testimony at this hearing will be heard from invited witnesses only. However, any individual or organization not scheduled for an oral appearance may submit a written statement for consideration by the Subcommittee and for inclusion in the printed record of the hearing.

BACKGROUND:

The IRS accounts receivable inventory is composed primarily of delinquent taxes owed by individuals, corporations and other taxpayers. At the end of fiscal year (FY) 1995, IRS gross accounts receivable equaled approximately \$200 billion, of which 28.5 percent (\$56.9 billion) reflected accrued interest and penalties. This is a \$29 billion increase over the FY 1994 balance. For the past several years, both the General Accounting Office (GAO) and the Office of Management and Budget have identified accounts receivable as a high risk area for the IRS.

To enhance the IRS's efforts to collect delinquent taxes, GAO has recommended that the IRS test the use of private collection companies to support its collection efforts (see e.g., GAO/GGD-93-67, GAO/HR-95-6). The FY 1996 Treasury, Postal Service and General Government appropriation (P.L. 104-52) directed the IRS to use \$13 million of the funds appropriated for Tax Law Enforcement to conduct a pilot demonstration project on the use of private collection agencies to secure delinquent tax debt. IRS issued a "Request for Proposals" on March 5, 1996, to solicit bids from private collection firms and attorneys for contracts to perform certain IRS tax debt collection activities.

H.R. 2234, the "Debt Collection Improvement Act of 1995" contains provisions to enhance the IRS's current authority to collect delinquent tax debt by establishing an automated levy system whereby the IRS would levy upon non-means tested Federal payments. Currently, the IRS has authority to levy upon property (including wages, salary, and other income) to satisfy delinquent tax debt. However, the IRS does not have an efficient, cost-effective process in place with which to identify delinquent taxpayers receiving Federal payments or to expedite issuance of notices of levy upon Federal departments and agencies making payments to delinquent taxpayers.

H.R. 757, introduced by Congressman Andy Jacobs (D-IN), would expand the authority under Internal Revenue Code section 6402 to allow for offset of Federal tax refunds to satisfy past-due State taxes.

FOCUS OF THE HEARING:

The Subcommittee will examine the composition of the IRS accounts receivable and the effectiveness of measures put into place over the past several years to improve its management of the receivables inventory.

The Subcommittee will also examine issues relating to outsourcing certain Federal tax debt collection activities, including: (1) the IRS's pilot private collection demonstration project; (2) legal issues relating to outsourcing, including consideration of which tax debt collection activities carried on the IRS are "inherently governmental" and must be performed by Federal employees, and measures needed to ensure taxpayers' privacy rights; (3) the types of activities that can be outsourced to private collection agencies; (4) the experience at the State level of outsourcing the collection of State tax debts; (5) options for compensating private debt collectors for tax debt collection services; and (6) the effect of using appropriated funds for private debt collection services instead of additional funding for collection efforts by IRS personnel.

In addition, the Subcommittee will consider the ramifications of provisions in H.R. 2234 to enhance the IRS's current authority to collect delinquent tax debt by establishing an automated levy system, and issues relating to expanding the authority under Code section 6402 to allow for offset of Federal tax refunds to satisfy past-due State taxes.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Any person or organization wishing to submit a written statement for the printed record of the hearing should submit at least six (6) copies of their statement, with their address and date of hearing noted, by the close of business, Thursday, May 9, 1996, to Phillip D. Moseley, Chief of Staff, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements the to have their statements distributed to the press and interested public at the hearing, they may deliver 200 additional copies for this purpose to the Subcommittee on Oversight office, room 1136 Longworth House Office Building, at least one hour before the hearing begins.

FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

- All statements and any accompanying exhibits for printing must be typed in single space on legal-size paper and may not exceed a total of 10 pages including attachments.
- Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.
- A witness appearing at a public hearing, or submitting a statement for the record of a public hearing, or submitting written comments in response to a published request for comments by the Committee, must include on his statement or submission a list of all clients, persons, or organizations on whose behalf the witness appears.
- 4. A supplemental sheet must accompany each statement listing the name, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or nummary of the comments and recommendations in the full statement. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press and the public during the course of a public hearing may be submitted in other forms.

Note: All Committee advisories and news releases are now available over the Internet at GOPHER.HOUSE.GOV, under 'HOUSE COMMITTEE INFORMATION'.

Chairman JOHNSON. The Subcommittee will come to order. Today, the Subcommittee will examine a number of Federal tax debt collection issues, including the status of the IRS' accounts receivable inventory; issues relating to the use of private collection agencies to assist in the collection of delinquent Federal taxes; provisions in H.R. 2234, the Debt Collection Improvement Act of 1995, relating to IRS levy authority; and H.R. 757, relating to the Federal tax refund offset authority for purposes of collecting delinquent State debts.

This hearing is held in furtherance of an exchange of letters between the Committee on Ways and Means and the Committee on Government Reform and Oversight during the deliberations on the Balanced Budget Act of 1995. Representative Steve Horn, Chairman of the Government Reform Committee's Subcommittee on Government Management Information Technology, offered an amendment to the Balanced Budget Amendment which embodied a modified version of H.R. 2234. A draft version of the Horn amendment contains several substantive tax provisions within the jurisdiction of this Subcommittee, including provisions relating to the IRS' use of private debt collection firms to assist in the collection of delinquent Federal taxes, provisions to give the IRS authority to impose continuous levies on non-means-tested Federal payments, and a provision to expand the Federal tax refund offset authority under the IRS Code, section 6402, to allow offsets of State tax debts.

At the request of Chairman Archer, these provisions were deleted from the Horn amendment and Chairman Archer and Congressman Horn entered into an exchange of letters with the understanding the Ways and Means Committee would review the provisions within its jurisdiction at its earliest convenience. The issues will be examined at the hearing today, including those items that were deleted from the Horn substitute amendment to H.R. 2234.

Mr. Horn will be testifying at the hearing this morning, as will the Ranking Democrat of the Government Management Subcommittee, Representative Carolyn Maloney. We welcome them to this Subcommittee and before that, we welcome our colleagues from this Subcommittee, Hon. Andy Jacobs and Hon. John Ensign, who will offer testimony on their bill, H.R. 757, relating to the expansion of the Federal tax refund offset authority for State tax debts. A similar provision was included in the Horn substitute.

Today, at this hearing, we will be looking at something that has been of great interest to me, personally, and that is the nature of what we call uncollectible taxes. Because part of dealing with this problem is to begin talking about what is uncollectible in a way that is more accurate and more specifically reflects reality; and in a way that will better communicate to the public what portion of that pot of about \$200 billion is collectible, what portion is not, and for what reasons under what circumstances.

I am interested in making changes in the law that will allow us to explain to ourselves, as a society, far more accurately what portion of the taxes due should have been collected and were not.

It is a pleasure to have you here, Mr. Jacobs and Mr. Ensign, and we will be happy for you to proceed.

[The opening statements of Ms. Johnson, Mr. Matsui, and Mr. Ramstad follow:]

Opening Statement of the Honorable Nancy L. Johnson Hearing to Examine Federal Tax Debt Collection Issues

Today, the Subcommittee will examine a number of federal tax debt collection issues, including: (1) the status of the Internal Revenue Service accounts receivable inventory; (2) issues relating to the use of private collection agencies to assist in the collection of delinquent Federal taxes; (3) provisions in H.R. 2234, the "Debt Collection Improvement Act of 1995" relating to IRS levy authority; and (4) H.R. 757, relating to Federal tax refund offset authority for purposes of collecting delinquent State tax debts.

This hearing is being held in furtherance of an exchange of letters last November between the Committees on Ways and Means and Government Reform and Oversight. During the deliberations on H.R. 2491 (the "Balanced Budget Act of 1995"), Representative Steve Horn, Chairman of the Government Reform Committee's Subcommittee on Government Management, Information and Technology, offered an amendment to the Balanced Budget Act which embodied a modified version of H.R. 2234.

A draft version of the Horn amendment contained several substantive tax provisions within the jurisdiction of the Ways and Means Committee, including: (1) provisions relating to IRS's use of private debt collection firms to assist in the collection of delinquent federal taxes; (2) provisions to give the IRS authority to impose continuous levies on non-means tested Federal payments; and (3) a provision to expand the Federal tax refund offset authority under Internal Revenue Code section 6402 to allow offsets for State tax debts.

At the request of Chairman Archer, these provisions were deleted from the Horn amendment and Chairmen Archer and Horn entered into an exchange of letters with the understanding that the Ways and Means Committee would review the provisions within its jurisdiction at its earliest convenience. The issues that will be examined at the hearing today include those items that were deleted from the Horn substitute amendment to H.R. 2234.

Mr. Horn will be testifying at the hearing this morning, as will the Ranking Democrat on the Government Management Subcommittee, Representative Carolyn B. Maloney. We welcome both of you to the Ways and Means Committee.

The first witness this morning is our esteemed colleague on the Committee, Representative Andy Jacobs, who will offer testimony on his bill, H.R. 757, relating to the expansion of Federal tax refund offset authority for State tax debts. A similar provision was included in the Horn Substitute.

OPENING STATEMENT OF CONGRESSMAN MATSUI

Subcommittee on Oversight Committee on Ways and Means Thursday, April 25, 1996

Today, the Subcommittee on Oversight will be discussing several very important issues about IRS's management and collection of delinquent tax debts. The public expects not only that IRS collect taxes in a fair and equitable manner, but also that IRS collect taxes due the Federal Government in an efficient manner. I look forward to hearing from the Administration about its proposals to streamline the tax debt collection process, as well as from State tax commissioners about their experiences in collecting delinquent tax debts.

The IRS's accounts receivable inventory currently is approximately \$200 billion, which reflects an increase of about \$29 billion since the end of fiscal year 1994. This level of uncollected taxes can not be ignored. It also is important to note that more than half of the IRS accounts receivable amount is what IRS calls "currently not collectible", and IRS has estimated that about \$46 billion is "collectible."

While it is true that no one loves the tax collector, I do think that it is very unfortunate that the fiscal year 1996 appropriations bill for the IRS cancelled one of IRS's major initiatives for collecting delinquent taxes. Specifically, I am referring to the Republican's failure to fund the second year of IRS's 5-year "compliance initiative" to collect over \$9 billion in additional revenues. During the first year of the initiative, IRS collected an additional \$803 million in taxes, more than double the amount expected.

Instead, the Republicans mandated that IRS spend \$13 million to establish a debt collection "project" using private collection agencies and attorneys. IRS will give private collection companies tax debt information on 125,000 taxpayers--individuals and businesses--in Alaska, Arizona, California, Colorado, Hawaii, Idaho, Montana, New Mexico, Nevada, Oregon, Utah, Washington, and Wyoming, for follow-up contact.

I want to note that the IRS Commissioner has been quite outspoken about her opposition to private debt collection in the tax area. The hard-fought taxpayer rights protections that this Committee, and particularly this Subcommittee, have developed over the past decade should not be cast aside in the search for a quick collection fix. Clearly, as IRS implements the mandated private debt collection "pilot program," it is imperative that IRS proceed carefully and protect taxpayer rights. At the conclusion of its test, I look forward to the results of the debt collection contract awards, and Treasury's analysis of the appropriateness of using private firms to collect delinquent Federal taxes.

In addition, the Administration proposes that the Committee adopt legislation to allow IRS to establish an automated levy process whereby 15% of a non-means-tested Federal payment would offset, on a continuous basis, to satisfy a delinquent Federal tax debt. While I recognize that IRS currently has broad authority to levy against taxpayer assets and income sources, including Social Security benefits, the Subcommittee should carefully analyze exactly how hardship cases and Social Security beneficiaries would be treated under an automated levy system. Of significance I should note that the non-tax debt collection provisions contained in the final fiscal year 1996 appropriations bill, which has been signed into law, provides Social Security beneficiaries with a \$9,000 annual exclusion, and Veterans with a complete exclusion, from administrative offset. I would hope that this Subcommittee would carefully consider the underlying policy and administrative rationale for providing such safeguards, in the context of Federal tax debts.

Finally, I look forward to hearing from my colleagues about the proposed offset of Federal tax refunds for certain State tax debts. Currently, more than 30 States, including California, offset State tax refunds for delinquent Federal tax debt. The States now seek reciprocal treatment from the Federal Government which I support. Congressman Jacobs and a distinguished panel of State tax administrators are here today to explain the value of providing State offset authority against Federal tax refunds, and their experience in refund offset programs to date. I personally would like to welcome Mr. Gerald Goldberg, the Executive Director of the California Franchise Tax Board.

Statement of Hon. Jim Ramstad

Before the House Committee on Ways and Means, Subcommittee on Oversight
April 25, 1996

Hearing on Federal Tax Debt Collection

Thank you, Chairwoman Johnson, for calling this hearing today.

It's always important, as we seek to privatize those functions of the federal government that can and should be contracted out, to make sure we are acting with appropriate deliberation and care.

While on its face the issue of whether to contract out to private debt collection services those cases which the IRS does not have the personnel to address seems to make sense -- especially given the fact that some \$200 billion in delinquent debt is currently in the accounts receivable inventory -- there are clearly complicated issues involved.

That's why it is important that this Subcommittee fully investigate the issue before recommending to the full committee the implementation of private collection of delinquent tax debt.

I look forward to the testimony of the witnesses and appreciate their coming here today to help us better understand the pros and cons of private collection.

Chairman JOHNSON. Mr. Jacobs

STATEMENT OF HON. ANDY JACOBS, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF INDIANA

Mr. JACOBS. Thank you.

The situation calls for me to be brief, Madam Chairman, and brief I shall be. The bill is H.R. 757. As far as I know, the only question about it is a so-called source tax which was outlawed prospectively but not retrospectively already and my suggestion is that this bill be amended to make clear that the same principal applies retrospectively, which is to say that any refund to any citizen of any State, a Federal tax refund, which is applied to a State tax could not be applied to—I should say a delinquent payment of a State tax—should not be applied in cases where that delinquency involves a source tax on the part of the State.

I think that would remove all controversy from the bill and probably all opposition to the bill. The whole idea is quite simple. Obviously, I am a former police officer who used to celebrate cooperation among police departments. God knows where we would be if we didn't have that cooperation, and this simply applies the same

principal to the Federal and State governments.

Right now, I think 31 State governments allow attachment by the Federal Government of refunds to their citizens where there is valid claim by the Federal Government for delinquent taxes from those respective citizens. So, this would really be a matter of reciprocity as far as those 31 States are concerned. It would induce the cooperation of other States in the two-way street of instruments to recoup delinquent taxes.

I should add that the bill provides that these are not just delinquent taxes in the opinion of the tax collectors, but where final adjudication has occurred that they are, in fact, delinquent taxes.

That is about it.

Chairman JOHNSON. OK.

Mr. Ensign.

STATEMENT OF HON. JOHN ENSIGN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEVADA

Mr. ENSIGN. Thank you, Madam Chairman.

I am very happy to hear what my colleague said about the amendment. That is the most concerning portion of the bill that affects residents from the State of Nevada or really any State who has people moving there from other States, especially retirees. The source tax was outlawed just recently and signed into law. It passed unanimously out of both the House and the Senate.

I recently had several townhall meetings on taxes in my district and I can tell you tax collection is one of the biggest issues with voters. Anything that concerns the IRS and expanding the powers of the Federal Government is very concerning to voters in my dis-

trict but, also voters, I am sure, across the country.

It is normally easier for political bodies to raise revenue by increasing enforcement mechanisms for taxes already in law than it is to raise revenue by passing new taxes or increasing current taxes. This is not to say I oppose attempts to enforce collection from those who have avoided paying taxes legally owed. In fact, in

the recently passed health care bill, my long-term care amendment was paid for by a provision that enforced collection from billionaires who renounced their U.S. citizenship for the purposes of avoiding U.S. taxes.

As Federal legislators, we not only have the right but we have the responsibility to ensure our government's tax collection methods are effective, efficient, but also fair. I want to stress the fairness issue because it is at the root of my concerns with specific provisions of these bills. On January 10 of this year, as I mentioned, President Clinton signed into law the repeal of the source tax.

H.R. 2234, the Debt Collection Improvement Act of 1995 and H.R. 757 contain one provision about which I am very alarmed. The provision is that which expands Federal tax refund offset authority to the States. I understand the Federal Government currently has the ability to offset State tax refunds in the States Mr. Jacobs mentioned and that these States seek reciprocity.

Although I have misgivings about the tax refund expansion to States in collecting claims from their residents, I will not focus on this provision. What I am strongly opposed to are the sections of the bill that allow States to grab Federal tax refund checks from

the residents of other States.

In my opinion, this would directly contradict the intention of the source tax repeal signed into law less than 4 months ago. And, in fact, it would allow States to recoup all past source-tax claims immediately upon enactment. It would also open up a new loophole for States to go after nonresidents.

As an example, for Federal tax year 1994, the IRS returned a little over \$87 billion to individual taxpayers in the form of Federal tax refunds. If, as I understand, about one-half of all the refund offsets would be taken from nonresidents, then that means about \$44 billion are available to be taken by the States from individuals who do not work, live, boat, play in the parks, or drive on the roads in the State that is taxing them.

In a time of tight budgetary times, such a policy would create tremendous incentives for States to look for ways to capture these refunds. There is also a concern regarding due process. Article V, section 1 of our constitution specifically addresses that States will

interact with each other in full faith and credit.

My point is that our judicial system currently has a mechanism for States to collect claims from residents of other States through the courts. While we might agree this is not the most efficient system, I would oppose short-circuiting the judicial system by allowing fiscally aggressive States to bill my constituents or any non-resident.

As a representative from a State that was deeply affected by the source tax, I can tell you we and any other representatives will have to answer letters from constituents who can't understand why another State is taking their Federal tax refunds.

Let us remember that just last week this House passed TBOR, the Taxpayer Bill of Rights, which was written and courageously passed by you, Madam Chairman and Mr. Matsui. I am sure that many would agree we must be very careful in the new ways we look to increase revenue collection to ensure we do not create another tax monster we cannot control.

Allowing States to tap into refunds of nonresidents or source tax 2, as I call it, is such a monster, and I urge this Subcommittee to oppose it.

Thank you, Madam Chairman, for allowing me to testify.

[The prepared statement follows:]

JOHN E. ENSIGN

WAYS AND MEANS COMMITTEE
SUBCOMMITTEE ON HEALTH
SUBCOMMITTEE ON HUMAN RESOURCES

RESOURCES COMMITTEE SUBCOMMITTEE ON NATIONAL PARKS, FORESTS, AND LANDS SUBCOMMITTEE ON WATER AND POWER RESOURCES



Congress of the United States House of Representatives

Washington, **AC** 20515–2801

April 25, 1996

STATEMENT OF REPRESENTATIVE JOHN ENSIGN

Before the Committee on Ways and Means Subcommittee on Oversight Hearing on Tax Debt Collection Issues WASHINGTON OFFICE:
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Good Morning Madam Chairwoman, thank you for allowing me the opportunity to testify before your subcommittee today on a specific matter in which I am very interested.

As the subcommittee is well aware, the level of debate surrounding our current system of taxation and the methods by which the government collects these taxes is at an all-time high. After a handful of town hall meetings back in southern Nevada 2 weeks ago, I can tell you how much interest my constituents have in both these areas because we spent hours discussing it. I believe it has raised the level of awareness of all elected officials who are in a position to make changes in our tax system.

It is normally easier for political bodies to raise revenue by increasing enforcement mechanisms for taxes already in law, than it is to raise revenue by passing new taxes or increasing current taxes. This is not to say that I oppose attempts to enforce collection from those who have avoided paying taxes legally owed. In fact, in the recently passed health care bill, my long-term health care amendment was paid for by a provision that enforced collection from billionaires who renounced their U.S. citizenship for the purposes of avoiding U.S. taxes. As federal legislators, we not only have the right, but we have the responsibility to ensure our government's tax collection methods are effective, efficient -- but, also fair.

I want to stress the fairness issue because it is at the root of my concerns with specific provisions of these bills. On January 10th of this year, the President signed into law a repeal of the pension Source Tax. For those not familiar with the Source Tax, it was one that Nevada legislators had been fighting for years because other states were abusing their ability to collect taxes deferred through pensions from prior residents of the state. It amounted to taxation without representation because individuals were receiving tax bills from states in which they hadn't lived for years or had never actually lived. This was wrong and its repeal was unanimously voted out of the House and the Senate on its way to becoming law.

H.R. 2234, the Debt Collection Improvement Act of 1995, and H.R. 757 contain one provision about which I am very alarmed. The provision is that which expands federal tax refund offset authority to the states. I understand that the federal government currently has the ability to offset state tax refunds and that the states seek reciprocity. Although I have misgivings about the tax refund expansion to states in collecting claims from their residents, I will not focus on this provision. What I am strongly opposed to are the sections of these bills that allows states to grab federal tax refund checks from the residents of other states. In my opinion, this would directly contradict intention of the Source Tax repeal signed into law less than four months ago. In fact, it would allow states to recoup all past-due Source Tax claims immediately upon enactment. It would also open up a new loophole for states to go after nonresidents.

As an example, for federal tax year 1994, the IRS returned \$87.3 billion to individual taxpayers in the form of federal tax refunds. If, as I understand, about half of all refund offsets would be taken by states from nonresidents, then that means that roughly \$44 billion are available to be taken by the states from individuals who do not live, work, vote, play in the parks, or drive on the roads of the state taxing them. In a time of tight budgetary times, such a policy would create tremendous incentive for states to look for ways to capture these refunds.

There is also a concern regarding due process. Article V, Section 1 of our Constitution specifically addresses that states will interact with each other in "full faith and credit." My point is that our judicial system currently has a mechanism for states to collect claims from residents of other states through the courts. While we might agree that this is not the most efficient system, I would oppose short-circuiting the judicial system by allowing fiscally aggressive states to bill my constituents or any nonresident. As a Representative from a state that was deeply affected by the Source Tax, I can tell you that we will have to answer the letters from constituents who can't understand why another state is taking their federal tax refunds.

Let us remember that just last week this House passed the Taxpayer Bill of Rights, which was written and courageously pushed through this body by Ms. Johnson and Mr. Matsui. I am sure that many would agree that we must be very careful in the new ways we look to increase revenue collection to ensure that we do not create another tax monster we cannot control. Allowing states to tap into refunds of nonresidents, or Source Tax II as I call it, is such a monster and I urge the subcommittee to oppose it.

Again, I want to thank you, Madam Chairwoman, and the other members for allowing me the opportunity to testify before the subcommittee. I am available to address your questions.

Chairman JOHNSON. Thank you, Mr. Ensign.

Before we proceed to question the two of you, I would like to ask our colleague, Mr. Horn, to come forward and make his comments. He needs to get back to chair a hearing, so, I would like to hear from him.

STATEMENT FROM HON. STEVE HORN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF CALIFORNIA

Mr. HORN. Thank you, Madam Chairman, and Mr. Matsui, Mr.

Hancock and, my good friend, Mr. McNulty.

I think what you are doing today in reviewing these issues is tremendously important for the average taxpayer. When we first examined this, the IRS situation, it was in the 103d Congress, when Gary Condit was my predecessor as Chairman of the Subcommittee. And, frankly, we were all very disturbed about how the financial records are kept and how the agency is managed and so forth.

When we got into the Debt Collection Act, and as you know Madam Chairman, that act is a product of the financial officer's council within the administration. Those are the 24 chief financial officers who are working to get a balance sheet for all Federal agencies by 1997. We have had the utmost cooperation of the ad-

ministration, of the chief financial officers.

This bill that is not before you but is part of the Omnibus Appropriations Act, but does not include anything under the jurisdiction of this Subcommittee, that bill came out of my Subcommittee on a bipartisan basis, while the Ranking Minority Member and I might disagree on one or two things, they probably are the ones before this Subcommittee, we have had the utmost cooperation of the Democrats on the Subcommittee, as well as the Republicans.

We want to thank you and your staff, Donna Steele, in particular, working with the chief professional staff member on my side on this, Mr. Brasher, who is with me this morning, and Chairman Archer has been his usual gentlemanly self, because I talked to him before I began hearings on this. We hope that you will be able to sort out, perhaps more efficiently than we were, the amount of

debt that the IRS has that it has not collected.

What shocked me when I got into this was the \$100 billion that they said, Well, we can't collect it. At that time, it was \$60 to \$64 billion in addition that they said they could collect. Well, I think the average taxpayer, when you are filling out your own forms and you are paying it and you are working 60 to 80 hours a week to find the money to pay the bills, rather resent that we have \$100 or whatever—and some say \$200 billion and I am going to let you sort that out—resent writing their checks when somebody is escaping with \$100 billion that is uncollectible.

In brief, the total Federal Government debt now that could be helped by what you are doing, I hope, and what we have been doing is equal to \$1,000 per person and child, elderly, whatever, in the United States. So, I think we do need to sort it out, and I think what you have before you this morning is, frankly, one of the major

keys to solving this riddle and puzzle.

The Internal Revenue Service and the Customs Service do not have explicit authorization to use private collection agencies. I realize that is controversial. The employee unions are very unhappy

with us. They want to collect the debt. Well, if they had collected the debt, we would not be here. They haven't collected the debt and I am willing to give them 30 or 60 days or whatever at first crack in collecting the debt but I am not willing, as a citizen—nothing to do with being a Member of Congress—I am just not willing as a citizen to say, Hey, folks, we are going to leave it only in your hands and we are going to have another \$100 billion uncollected.

I think it is a scandal. I think the agency has been mismanaged, it is not new. As I said, the financial records and audits when they came before us in the 103d, Mr. Cox, who was the Ranking Republican on the Subcommittee said, If a corporation brought that balance sheet to you, you would have them indicted. And it is a pretty sad situation and I hope, together, that your Subcommittee and my

Subcommittee can help sort some of these things out.

They say, Well, gee, there is a problem of confidentiality. Well, sure, there is. We don't have confidential tax records turned over to the private collectors. You don't need to do that. All you need to do is get the debtor's name, address, telephone number, and the amount of the debt. And you can write the Codes, just as many progressive States have done, that you can't go around saying so-and-so owes a tax debt. You knock on the door, you phone them up, whatever, and you try to get them into a situation where they can work out the payoff of what they owe the people of the United States, because that is who it is. It is hurting us when we don't collect that debt.

And, of course, is this a radical step? I don't think so. In 1993, Mr. Gore's National Performance Review recommended it in reinventing government. Two subsequent administration budgets in fiscal year 1994 and 1995, though not the current one, recommended it. The fiscal year 1996 Treasury Postal Appropriations bill recommended it. The General Accounting Office, our agent, the legislative branch to oversee the Federal financial operations, they have recommended it. And it is worth noting, that 30 States have private debt collectors who go out and collect the tax debt.

And on that subject, I must say just as an aside, I think Mr. Jacobs has made an excellent suggestion here and I hope the Subcommittee will look favorably on that. We need to have reciprocal

cooperation between States and Federal Government.

So, as I mentioned earlier, the management problems at the IRS are major. And all of us, appropriations, your authorizing Committee, our oversight Subcommittee, we need to work together to help the IRS get the proper computer equipment, whatever it takes, to help do the job. But we can't just say because a few people are upset that we can't go out and collect \$100 or \$150 billion—and I know you are going to sort that out for us today and I wish you well on that—but Congress also needs to enact a provision for the continuous levy of Federal benefits to satisfy tax debts.

Now, we are taking good care of the ones that are not under your jurisdiction but what got me really started on this is when a person that owed the Farmer's Home Administration \$3 million for an operation he had in northern California, refused to pay it, and was given another loan when he took on an office building in Santa Barbara and built himself a million dollar home. I just don't think you can escape paying your Federal obligation and go off living high on the hog. That is sort of reminiscent of the savings and loan scandals.

So, I wish you well and I support Mr. Jacobs' bill. I think it is absolutely essential if we are going to get the job done that we have to have private collectors authorized to do the work.

Thank you, Madam Chairman. [The prepared statement follows:]

STATEMENT OF HON, STEVE HORN

Madam Chairman and Members of the subcommittee:

We are pleased to be here today to assist in your review of IRS' collection practices. Every year IRS successfully collects over a trillion dollars in taxes owed the government, yet at the same time tens of billions more remain unpaid.

My testimony today discusses the debt collection challenges facing IRS and the potential benefits of involving private debt collectors in the tax debt collection process.

A number of long-standing problems have complicated IRS' efforts to collect its accounts receivable. Of foremost concern is the lack of reliable and accurate information on the nature of the debt and the effectiveness of IRS collection tools.

Without reliable information on the accounts they are trying to collect and the taxpayers who owe the debts, IRS agents generally do not know whether they are

resolving cases in the most efficient and effective manner and may spend time pursuing invalid and unproductive cases.

IRS also does not have reliable data on the effectiveness of its collection activities and programs. Consequently, it is unable to target its efforts specifically to the taxpayer and tax debt in question. IRS is currently trying to capture this data on its Enforcement Revenue Information System and other computerized systems. However, there are questions about the accuracy of the data produced by these systems.

The age of the debts in IRS' accounts receivable inventory is also a problem. IRS' inventory of tax debt includes delinquencies that may be up to 10 years old. As a result the inventory includes old accounts that may be impossible to collect.

In addition, the age of the receivable does not reflect the additional time it takes for IRS to actually assess the taxes in the first place. It may be up to 5 years from the date the tax return is due before IRS assesses the additional taxes. The age factor significantly affects the collectibility of the debt because as both private and public sector collectors have attested, the older the debt, the more problematic collection becomes.

Another factor relating to the collectibility of tax debts owed by individuals is source of income.

Taxpayers earning their income from nonwage sources, such as pensions, self-employment, and investments are more likely to be delinquent in paying their taxes and often owe more than wage earners who have their taxes withheld. According to IRS data 74 percent of its inventory of tax debts owed by individuals is owed by taxpayers whose income was primarily nonwage. The average tax delinquency for these taxpayers was about 4 times greater than that of wage earners—\$15,800 versus \$3600.

IRS collection process is also a problem in that it was introduced decades ago, and is generally costly and

inefficient. While the private sector emphasizes the use of the telephone, a significant portion of IRS collections resources are in field offices where personal visits are made.

Updating its computer systems is another challenge facing IRS. Modernized systems could provide IRS collectors with on-line access to the information they need when the need it. Modernized systems would also help provide the management information needed to evaluate the effectiveness of IRS collection tools as well as the ability to adopt flexible and innovative collection approaches.

Moving now to the potential benefits of involving private collectors in federal tax debt collection, we believe these entities offer the potential for improving IRS debt collection practices. In May 1993 we recommended IRS test the use of private collectors to support its collection efforts. Many states use private collectors to supplement their own collection programs, thereby taking advantage of private sector capability in

managing receivables, gaining access to better technology, or avoiding the expense of hiring permanent staff.

Last month as directed in its 1996 appropriations act, IRS issued a request for proposals from prospective participants in a pilot private debt collection program. Under the pilot, the private collectors are to attempt to first locate and then contact delinquent taxpayers, remind them of their tax debt and inform them of available alternatives to resolve the outstanding obligation. An important limitation of the pilot is that the private collectors will not be able to actually collect the taxes owed; rather they will facilitate information exchange and contacts between IRS and the taxpayer.

During the pilot, the private collectors will face some of the same problems in working the pilot cases that IRS employees face. First, these are not new cases. All will have already gone through much of IRS collection process, and in some cases, the entire process. This

means in effect the debt may be 10 years old. The cases may also contain some of the other information problems we discussed easier.

Regardless, the pilot could provide useful insight into the effectiveness of the techniques and technologies used by the private sector. For example, the pilot calls for 40 percent of the cases to be those in which IRS has been unable to locate or contact the taxpayer. The remaining 60 percent are cases in which IRS has successfully contacted the taxpayer, but has been unsuccessful in securing payment. To the extent that the private collectors can locate, contact, and arrange for payment on these cases, the techniques used may be helpful to IRS. Other useful information could also be obtained on what collection actions are most productive based on the type of case, type of taxpayer, and age of the account. Using the states' experience as an indicator, IRS can expect some additional collections from its proposed pilot, but not necessarily a significant windfall.

In closing Madam Chairman, IRS faces many challenges in its efforts to improve the management and collection of its accounts receivable. The key is to find solutions to the underlying causes of the problems that affect IRS' ability to collect delinquent taxes. Solutions will take time because the problems are pervasive and may involve all IRS functions and processes.

As we have previously recommended, IRS needs to develop a detailed and comprehensive long term plan to deal with the challenges it faces and their interrelationships.

With such a plan, IRS could better assure itself and Congress that it is on the right track.

Madam Chairman, that concludes my statement. I would be happy to answer any questions the subcommittee may have.

Chairman JOHNSON. Thank you, Mr. Horn.

I appreciate the good work of your Subcommittee on this subject, and we look forward to working with you to assure that we have a good bill in place. It is very important, I think, to straighten out what is what in this area because of the \$200 billion in "uncollected taxes," about \$60 billion is interest and penalties, and about \$20 billion is taxes that we agreed, in the savings and loan negotiations, not to collect and about \$20 billion is liability that was added in when we extended the statute of limitations from 6 to 10 years and the likelihood of collecting that debt is very small.

So, I think we need to really understand more clearly what is in our \$200 billion pie and, therefore, what resources we need, what of those resources the government ought to supply, and what the appropriate role of the private sector is in helping us better assure that all citizens pay their fair share of our government service's

costs.

I do want to just recognize my Ranking Member, Mr. Matsui, who has been a really strong ally as we work through a number of issues on this Subcommittee.

Bob.

Mr. MATSUI. Thank you very much, Madam Chairman.

I want to thank you for calling these hearings and certainly I apologize for being late. I was at a Democratic whip meeting and was able to finally get out. I understand you submitted my written statement for the record and I appreciate that.

Is it appropriate now for me to ask a couple of questions?

Chairman JOHNSON. Certainly.

Mr. MATSUI. Thank you.

I am just going to ask Mr. Horn and Mr. Ensign—and that is not because I just want to talk to Republicans—I am already on Mr. Jacobs' legislation as a cosponsor, so, I won't need to ask him questions.

But, John, and again, whenever you, from Nevada, bring up an issue I always get worried as a Californian. But, let me ask you because you raised an interesting point here and I want to understand it, because I think there may be some legitimacy to it. If, in fact, there is a State which is due State taxes and has a judgment—and I don't know quite how they obtain a judgment—but assuming they have a judgment, they would be able to go to the State of the residents of the one who is the taxpayer who owes the money. I use California and Nevada, it is easier that way. Go to Nevada, go to the court system there and then levy on the assets of the individual.

Now, if, in fact, there is a legitimate court decision from California, what would be the problem of allowing the State of California then to get the offset from the Federal Government on Federal taxes? It would seem to me you could skip the step of having to go to the Navada court. You can reverse it but

go to the Nevada court. You can reverse it, but——
Mr. ENSIGN. From what I understand in this legislation and where the problem comes in is that the State of California that levies this legally collectible debt, the person has to then go back to the State of California and it puts more of the burden on the individual. I am not a lawyer so I don't know the legal technicalities of this, but from the information that I have received, that is a big

problem. Now it takes this resident—if they disagree with whatever the ruling is—they have to go to the State of California and fight it in court.

Mr. MATSUI. I don't want to take a lot of time because I know

we have a number of panels. But assuming that the—

Mr. ENSIGN. Because right now these are legally collectible debts under the courts.

Mr. MATSUI. Right. Assuming the debt is a legally collected debt and it has gone through the judicial process in California, then they could levy in the State of Nevada. I would imagine that if it is a bona fide judgment that it is due anyway. In other words, they have already gone through a judicial process. That is the part I—I mean I understand you wouldn't want to put a resident of Nevada or another State in a position where they would have to contest it across jurisdictional lines necessarily.

Mr. Ensign. We would certainly be willing to look into this, and work and if that is the case, then that is the biggest concern. And if that is something we can work out, we would be more than

happy to

Mr. MATSUI. I think maybe we are trying to reach the same point and I appreciate your raising it though because it could obviously

be a legitimate issue.

Steve, can I just ask you one question. In terms of the private debt collectors, would you be willing to come up with some standards, maybe your Subcommittee in offering to us, because we want to ask, obviously, the agencies that same question. What kind of standards should we have in terms of the debt collectors?

You know there are some that are good, some that are not good.

Mr. HORN. Like confidentiality standards essentially.

Mr. MATSUI. Well, I think confidentiality standards, but also others. You know when I was a practicing lawyer, I told this to my staff. This goes 20-plus years back. The first thing I did because I was just starting off opening my own office, a debt collection agency said, you want to handle our work? And they gave me a flat fee, whatever it was, it wasn't a lot of money then. But after about 2 months I said I have to get rid of this because it was ruining my reputation. Those folks were levying on everyone and making midnight calls. It was a really scary situation. And I probably would have been disbarred if I would have kept this firm that I was allegedly representing, but they were doing bad stuff.

Since that time, the Unruh Act passed California, so there are some built-in protections. But one still needs to be careful because some of these folks come and go and would you propose standards? Because I would think that we would need to develop some level of standards if, in fact, we did do this in a way that was wide-

spread.

Mr. HORN. Yes. I think you are absolutely right. We should have standards when we let a Federal contract to do some of the Federal business, if you will. We will be glad to work with you on that.

There has been great progress made in many States.

You mentioned our own State, where you just don't do what you did 20, 30 years ago. I realize the reputation still sort of sits there but it has advanced far beyond that. And they obviously have to follow the rules on it, just as the IRS agents would follow the rules

on it. It is just simply a matter of management, getting the job done, and putting it out. You could bid some of the paper to have them bid on it, but we just can't let it sit there unprocessed, not followed up on. That is what concerns me as a taxpayer.

Mr. MATSUI. Thank you.

Chairman JOHNSON. Mr. Hancock.

Mr. HANCOCK. I don't think there is any question a lot of people are upset about the fact that some people seem to be able to participate in our society without paying their share. I think also the people that are paying their share think they are paying way too much of a share.

My question to you would be, How do you envision, when you start talking about private debt collection of \$200 billion, maybe \$150 billion, whatever the figure is, How do you envision the collec-

tors being reimbursed?

Mr. HORN. I think I can give you one way to do it and this is clearly within your jurisdiction. The financial management service of the Department of the Treasury has an excellent reputation, I think, on the Hill and just by objective observers as a well-managed organization. And for the debts that are not collected, regardless of agency, whether it be Treasury, Agriculture, Education—Education has the second most outstanding debt. If we sent the debt that is owed over to financial management, let them review it, let the contracts. It could be by bid basis. You could retain people based on experience that have a proven record, just as you would grant any other contract under the Federal Government.

And it ought to be the quality of work as well as how much you collect. Some of this debt is clearly uncollectible. You have a small two-person business, it went bankrupt, couldn't pay the taxes, was not paying Social Security, they were using it to be cash flow. We have all had those cases in our offices. And we know it exists na-

tionwide.

So, somebody has got to analyze that debt, sort it out, and if the private sector wants to bid on it that is one way. Retaining agencies by contract is another way, but you would have to prove a record of effectiveness.

Mr. HANCOCK. Well, naturally most private debt collection agencies operate on a percentage of what they collect.

Mr. HORN. Right.

Mr. HANCOCK. I am assuming that that is the same approach you would have to take for a government program.

Mr. HORN. Sure.

Mr. HANCOCK. Now, there is another question I would like to ask. Here again, it is kind of getting into the technicality of this thing. In some cases when you send an individual out to collect a debt, if you make the percentage big enough then they have got some room to negotiate the collection to get it settled.

That is where I am having a little bit of a problem. I don't think that we should try to indicate, if there is a \$100 billion collectible, that the government is going to end up with \$100 billion. The government is not going to end up with it, but instead maybe \$50 bil-

lion, maybe \$40 billion, and maybe less than that.

Mr. HORN. Yes. I would be happy with \$5 billion. I just want to get something out of it.

Mr. HANCOCK. I suppose that would be correct.

Mr. HORN. Let me just add something, if I might, Mr. Hancock, that one of the things we might also think, and this is clearly something you would have to wrestle with here, is an incentive for agencies to collect. And we had in one draft—did we get it in the final one? What is the percentage, 3? Oh, it is 5, OK. We would give the agency that collected this debt 5 percent which they could use in their budget. Now, obviously, the Appropriations Committee or the authorizing Committee could say, Wait 1 minute, what are you going to do with that 5 percent? But we would have it applied to things that help in debt collection, such as better computer technology. That would give the executive in that agency flexibility to really get the system up to speed.

Mr. HANCOCK. Well, I agree with that, but let's don't put them

on a commission basis, if you don't mind.

STATEMENT OF HON. CAROLYN MALONEY, A REPRESENTA-TIVE IN CONGRESS FROM THE STATE OF NEW YORK

Mrs. MALONEY. If I could add, Mr. Hancock, I would like to request my testimony be put in the record in full, but in response to your first question about incentives. It is perfectly legal for the private sector to have incentives in collection of debt but the Taxpayers' Bill of Rights strictly prohibits the IRS from using enforcement goals or quotas. And also, whereas an IRS agent can be sued under the Taxpayer's Bill of Rights, a private collector cannot be.

For many years as a member of the city council, I conducted a study on what was owed the city. I did the same thing here and found that billions of dollars was owed the Federal Government in fines, fees, royalties, and then in the IRS. And our bill that we have worked jointly on is, I think, an excellent bill, but the one area where we do disagree is that I do not believe the Federal Government should use private collection agencies to collect debt that is owed.

I think we, as a government, can have oversight of the IRS, which we have, on ways that they can improve their collection, but I feel the people need a trust with their Federal Government, that there would be problems about privacy and historically when private collectors have been used it has been one that has resulted in a lack of trust and sometimes in a very ugly situation.

Most private collectors require at least 30 percent of the take. I think we can probably get more money in if we improve the techniques of the IRS. I feel one of the important parts of government is to have a trust between people and their government and to start using private debt collectors, clearly, violates the Taxpayers' Bill of Rights.

But I think the bill has many positive parts in it, centralizing collection and really commonsense approaches to collecting debt that is owed the Federal Government. But I do disagree on that one particular aspect.

[The prepared statement follows:]

Testimony of Congresswoman Carolyn Maloney

Thank you madam Chairwoman, members of the committee. I am delighted to be here today to talk to you about tax debt collection issues. Two of these issues are particularly important to me: enhancing the IRS's levy authority and giving the IRS the ability to use private collection agencies.

The first issue I wanted to talk about expanding the IRS levy authority. Congressman Horn and I have worked long and hard on a bipartisan debt collection reform bill, HR 2234. If passed, this bill would greatly improve the collection of debt across all of the agencies. One of the most important debt collection tools that our bill uses is the enhanced IRS levy authority tool.

Our bill would authorize the Internal Revenue Service (IRS) to automatically levy upon non-means tested Federal payments. For example, if a Federal employee was delinquent in paying their Federal tax, the IRS could levy a percentage of that employee's salary. This action would help recoup the delinquent tax and it would help reduce the deficit. According to the Administration's estimate, the automated levy provision would reduce the deficit by \$1.4 billion over 5 years.

That money belongs to the American people. As Congress continues to cut vital programs that benefit millions of Americans. I am pleased to offer this positive alternative.

The second issue involves allowing the IRS to use private collectors which sets a bad precedent. This country has never turned over the business of collecting Federal taxes to the private sector. The founders of the Constitution thought it was a bad idea, and so do I. Here are my concerns:

- The public already has a low opinion of the IRS By using private collectors to
 collect personal taxes, the public's perception of the fairness of tax collection
 would only get worse. Private sector collectors who work on commission are not
 going to care whether their actions antagonize taxpayers, or erode the credibility
 of the IRS.
- Using private collectors clearly violates the Taxpayers Bill of Rights on many
 accounts Bill collectors could circumvent the intent of the Taxpayer Bill of
 Rights by paying a commission to collectors. Although this is perfectly legal in the
 private sector, the Taxpayer Bill of Rights strictly prohibited the IRS from using
 enforcement goals or quotas. Also, whereas a reckless IRS agent can be sued
 under the Taxpayers Bill of Rights, a private collector cannot be.
- Using private collectors clearly violates the privacy rights of all taxpayers Many taxpayers would decide to no longer comply once they learn that their tax
 information would be shared by private sector employees who operate outside of
 the Government's confidence. As a result, we may end up collecting less.
- The IRS can collect taxes better than private collectors The IRS has had proven successes in collecting taxes owed. For example, the IRS telephone collection efforts yield about \$26 collected for every dollar expended. More complex and difficult cases dealt with in the field yield about \$10 for every dollar spent. Reforming the IRS does not mean cutting resources and staff or using private collectors, it means making the IRS more easy to use, more modernized and more efficiently run.
- The use of private collectors will cost the IRS money and resources The Congress has cut funding levels and has forced reductions in staff for the IRS. However, to start up and run private collector programs, the IRS will need additional people to provide the necessary management and oversight of contractors.

No one likes to pay taxes, but the majority of the American people know that the system now in place aims to strike a balance between protecting the rights and privacy of taxpayers and collecting taxes owed. Using private collectors would tip this balance in the wrong direction.

Mr. HERGER [presiding]. Mr. Laughlin, do you have a question? Mr. LAUGHLIN. I have a brief question for Congressman Horn. In your testimony you were talking about some areas that were going to be impossible to collect. I think you used the word, two-man, two-person company that went bankrupt. Do you have any suggestions on whether this debt that is owed the Federal Government ought to be identified in some way, and how would you go about identifying that debt that is either legally or monetarily, financially impossible to collect even in the next 50 years?

Because it seems to me when we are sitting here talking about \$150 million, \$200 billion owed to the Federal Government, that it is deceptive if that figure contains an amount that is impossible to

collect for whatever reason.

Mr. HORN. Well, I think we have got to look at the individual and their own taxpayer number. I'm not sure they have carefully followed up on that. When you have got somebody going out of business and suddenly declaring bankruptcy, we are not very good at finding when they have popped up again. And if they have popped up again and are simply bleeding their creditors and bleeding the taxpayers and the IRS on our behalf, then I have got a real problem, as a citizen, with that kind of conduct.

You and I know there are just too many people claiming bankruptcy. Some are very legitimate. We shouldn't interrupt with that chance to reorganize the finances of a business. On the other hand, if there is a pattern and a practice of deceit to avoid taxes, then we ought to be on top of that. And when the file is cold, it is a little

hard to be on top of it.

You need to call when there is a debt, certainly, within 30 days. Pretty soon the person has just forgotten they owe you the debt, hadn't heard from you, no decent followup, not even by mail. We

have got a real mess in this situation.

That is why I would say I would give the government agency 30 days. I would be willing to, if you want to give them 60 days, that's fine, but then let's get to work and get the job done. In fact, let's put them in competition. I think that would sharpen up the Federal agencies to be more effective than they've been. They have certainly not been effective, given the current record. Even if there is \$100 billion, that would be impossible from the beginning. I don't believe there is a \$100 billion from the beginning. I think starting in 1990 when they just started forgetting about a lot of this stuff, is when our problems began. They began in 1990, 1992, 1993, 1994, and 1995, right now. And we need to get it stopped.

Mr. LAUGHLIN. Thank you very much. Mr. HERGER. Thank you very much.

And, Mr. Jacobs, I apologize for not being able to be here for your earlier testimony, but I understand you mentioned you would work with the Subcommittee on amending your bill, particularly with the collection.

Mr. JACOBS. Absolutely. That's an exception to the spirit of what we already passed. It should have been retroactive.

Mr. HERGER. On the postdue source taxes.

Thank you very much.

We do have a vote going, so we will recess. We will come back. [Recess.]

Mrs. JOHNSON [presiding]. The Subcommittee will resume. The hearing will resume with Cynthia Beerbower, Deputy Assistant Secretary for Tax Policy, the U.S. Department of the Treasury; and James Donaldson, Chief, Tax Service/Acting Chief Compliance Officer, Internal Revenue Service; to be followed by Lynda Willis, Director, Tax Policy and Administration Issues, U.S. General Accounting Office.

STATEMENT OF CYNTHIA G. BEERBOWER, DEPUTY ASSISTANT SECRETARY FOR TAX POLICY, U.S. DEPARTMENT OF THE TREASURY

Ms. BEERBOWER. Thank you, Madam Chairman.

I am pleased to appear before you today to discuss some of the tax policy issues related to Federal debt collection practices and, in particular, the outsourcing of Federal tax debt collection. My written statement addresses each of the particular issues that you have asked us to discuss. And so, in the oral testimony I will just summarize the written testimony that we have already provided this morning.

The administration remains dedicated to protecting the rights of taxpayers in connection with our debt collection activities. We have worked in a bipartisan effort with this Subcommittee on TBOR, the Taxpayer Bill of Rights 2 legislation which, as you know last week was approved by the House, by a unanimous vote. Having established these very significant safeguards of taxpayer rights in TBOR 2, we are concerned these protections could be bypassed by a hastily conceived outsourcing of Federal tax debt collection to private contractors.

These private debt collectors are not subject to TBOR 1, or to TBOR 2, or to other provisions of the Internal Revenue Code that have been carefully designed over many years by this Subcommittee and by prior administrations to protect the rights of taxpavers.

We recognize there is a natural and inevitable tension that arises between guarding taxpayer rights and vigorously pursuing tax receivables. We appreciate a delicate balance must be achieved between urging increased collection productivity to reduce the inventory of Internal Revenue Service accounts receivable but, at the same time, perhaps slowing the process to guarantee that important taxpayer rights and safeguards are secured.

We would urge the Subcommittee to approach the subject of outsourcing Federal tax debt collection cautiously and carefully this morning and to evaluate any change in the system to make sure it is consistent with our shared concerns for taxpayer protections.

Tax collection is a unique area. Its uniqueness is reflected in the many checks and balances that are written into our current law to limit how the IRS must conduct collections. Not just the Taxpayer Bill of Rights, the two of them, but other provisions of the Internal Revenue Code that protect the unique and often, very private nature of information that is supplied to the government on one's tax return. Current government procurement law dictates certain collection activities are highly discretionary and they may not be able to be contracted away from Federal employees. The Prompt Deposit Act will constrain methods of compensating private contractors.

A key element of any proposal to privatize tax debt collection must be to evaluate the legal issues involved in these checks and balances and determine the extent of changes the Congress must make in these laws before plunging into the privatization of tax debt collection.

As you know, H.R. 2020, the Treasury Postal Service and General Government Appropriations Act of 1996 has authorized funding for a pilot program to test private debt collection of Federal taxes, and the IRS has this project underway. This pilot provides an opportunity to evaluate some of these issues.

I also comment directly in my written remarks on the methods of compensating private debt collectors. TBOR 1 prohibited the IRS from using amounts collected as a criterion for evaluations or compensation of IRS employees. We are aware and heard earlier this morning that contingent arrangements are commonplace in the private sector and that performance evaluations of employees usually reflect the extent of their collections in this area. We believe for the same reasons Congress was concerned about the compensation being based, perhaps, on collection activities, that we should similarly be concerned in any type of private debt collection initiative.

I also touch in the written testimony on two specific legislative proposals. First, H.R. 757, introduced by Mr. Jacobs, which would enhance the cooperation between Federal and State tax administrators by permitting Federal tax refunds to be offset to collect delinquent State tax debts.

The Federal Government already benefits by many States participation in the State Income Tax Levy Program under which States offset State tax overpayments by past due Federal tax debts.

We have testified on this subject before and we believe that reciprocal cooperation should be afforded by the Federal Government to the States. We support expanding the refund offset program to cover the State tax debts.

The other legislative proposal, H.R. 2234, originally contained proposed changes in the IRS' levy authority. And one of the provisions that was contained in that bill would have permitted a continuous levy to be made on certain types of recurring Federal payments we think would eliminate a lot of the repetitive paperwork burden that the IRS goes through. This provision would not change the kinds of property the IRS can reach with its levy authority. The bill also makes some changes in section 6334, exemptions from levy.

In conclusion, we obviously recognize that Federal tax debts must be collected. If a taxpayer pays his share of tax revenue that supports his government, he has a right to expect that others who don't pay their share should be vigorously pursued and collection efforts should result. However, before we make changes in our collection practices, we should do so only in a conscientious and thoughtful way considering all of the ramifications.

That concludes my oral testimony, and I am pleased to answer any questions that you have.

[The prepared statement follows:]

STATEMENT OF
CYNTHIA G. BEERBOWER
DEPUTY ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES

Madam Chair and Members of the Subcommittee:

I am pleased to appear before you today in response to the Subcommittee's request to discuss some of the significant tax policy issues related to Federal debt collection practices. My testimony today will address the issues that you have expressly directed toward the Office of Tax Policy. In particular, you have asked for our comments on three issues related to outsourcing Federal tax debt collections: (1) which collection activities carried on by the Internal Revenue Service ("IRS") are "inherently governmental" and must be performed by Federal employees; (2) the appropriate method for compensating private debt collectors for tax debt collection services; and (3) the potential costs and benefits of using appropriated funds to contract with private debt collection agencies for Federal tax debt collection services compared to providing additional funding for collection efforts by IRS personnel.

You have also asked for our comments on (4) H.R. 757, which would expand the authority under section 6402 of the Internal Revenue Code of 1986 to offset Federal tax refunds to satisfy past-due State tax debts, and on (5) specific provisions of H.R. 2234, "The Debt Collection Improvement Act of 1995," that would enhance the IRS's authority to collect delinquent tax debts by establishing an automated system of levying on certain non-means tested Federal payments. After some preliminary comments on general policy issues raised by the private collection of delinquent taxes, I will discuss each of these five specific topics.

General tax policy concerns about private debt collection

A number of policy issues arise in the context of any tax debt collection proposal, and we would urge the Subcommittee to approach the topic of outsourcing tax debt collection especially cautiously. As you know, representatives of this Administration have previously expressed concerns about contracting out the collection of Federal taxes to private agencies. See, e.g., Letter from Commissioner of Internal Revenue Margaret Milner Richardson to Senator David Pryor (August 4, 1995), reprinted in 141 Cong. Rec. S11538.

The Treasury Department too has concerns about turning over collection activity to private contractors.

First, this Administration and this Subcommittee are dedicated to protecting the rights of taxpayers in connection with our debt collection activities. In this regard, I want to commend the Committee on Ways and Means and the entire House of Representatives for their recent passage of the Taxpayer Bill of Rights 2 ("TBOR 2") legislation. The significance of taxpayer rights and the broad bipartisan support for protecting them are clearly reflected in the unanimous vote of the House to approve that bill. The Treasury Department has been very pleased with the bipartisan cooperation that has been demonstrated in developing and refining the provisions of this legislation.

As you know, our commitment to taxpayer rights has led us voluntarily to implement many of the TBOR 2 provisions through administrative actions. In January of this year, we issued a Notice discussing the TBOR 2 items that we would be undertaking administratively, see Announcement 96-5, "Administrative Initiatives to Enhance Taxpayer Rights," 1996-4 I.R.B. 99, and in late March we announced that the 17 specific TBOR 2 items identified in the Notice have all been implemented. This effort to accomplish administratively as much of TBOR 2 as was feasible under our authority provides tangible evidence of the Administration's ongoing commitment to protecting the rights of citizens in their contacts with the Federal tax system.

There is inevitably a tension between protecting taxpayer rights and aggressively collecting tax receivables. In its recent report, the General Accounting Office ("GAO") expressed "concern" that "the IRS may be sending the wrong message to its collection employees" by such actions as prohibiting the evaluation of collection employees based on amounts collected, increasing the use of installment agreements, and making additional use of offers in compromise. General Accounting Office, Internal Revenue Service Receivables 25-28, Report No. GAO/HR-95-6 (1995). We are concerned that the protection of taxpayer rights not be sacrificed in the enthusiasm to increase tax collections. Congress (in the first and second Taxpayer Bills of Rights) and the IRS (in our administrative TBOR 2 initiatives) have taken significant steps to ensure that taxpayers are treated fairly throughout the collection process. It would be, in our view, inappropriate to apply these taxpayer protections to the activities conducted by the IRS but not to private collection contractors. At a minimum, therefore, we think it would be necessary to require that private contractors respect all provisions of the law governing taxpayer rights.

Second, we are concerned about the difficulties that would result from disclosure of taxpayer information to contractors. As the Subcommittee knows, section 6103 of the Code protects the confidentiality of taxpayer return information, and the Administration firmly supports the policy behind this provision. Disclosures of return information may be inevitable under any system of privatized tax debt collection. What if individuals or entities that are in the business of debt collection duplicate IRS data or merge that information with their own private data bases? Disclosure to contractors will also present the IRS with more individuals and more physical locations that it must supervise and audit for compliance with security conditions and safeguards

under section 6103(p) of the Code. Thus, any private system of tax debt collection must comply strictly with the privacy restrictions of section 6103 and related statutes.

In sum, we recognize that taxes must be collected, and that the system requires that where one taxpayer has paid his share and another hasn't, the IRS should pursue collection from the delinquent. However, the Administration believes that the important goal of improving debt collection procedures must be consistent with protecting taxpayer rights and maintaining taxpayer privacy and confidentiality. The proper resolution of this issue lies in a careful balance between these two aims and in thoughtful and well-considered implementation of any proposals.

As you know, however, in H.R. 2020, the Treasury, Postal Service and General Governmental Appropriations Act of 1996, Congress authorized \$13 million for the Treasury Department to conduct a pilot program to test private collection of Federal tax debts, and the IRS has the pilot project underway. This provides an opportunity to evaluate the issues inherent in outsourcing of debt collection.

I will now turn to the specific topics you have asked us to comment on.

1. "Inherently governmental" functions

The Constitution provides that Congress has the power to levy and to collect taxes. Congressional authority to collect taxes has been given to the Secretary of the Treasury. Tax collection is intrinsic to government as an exercise of the state's sovereign authority, and the Supreme Court has held that sovereign powers generally cannot be contracted away. See Contributors to Pa. Hosp. v. City of Philadelphia, 245 U.S. 20 (1917); Texas & New Orleans R.R. Co. v. Miller, 221 U.S. 408 (1911). A key element of any proposal to privatize tax debt collection must be to evaluate the legal issues surrounding any attempted delegation of authority. In particular, there may be impediments to outsourcing tax debt collection functions under current Federal procurement acts.

For example, functions cannot be delegated by contract to persons other than officers or employees of the United States if those functions are "inherently governmental," which the Office of Management and Budget describes as "so intimately related to the public interest as to mandate performance by Government employees," such as activities that require the exercise of discretion in applying Government authority or that involve tax collection. See Office of Management and Budget, Circular No. A-76 (August 4, 1983); Office of Management and Budget, Policy Letter 92-1, 57 Fed. Reg. 45096 (Sept. 30, 1992).

Examples of tax collection powers that would <u>not</u> be delegable under current law would presumably include the authority to compromise a tax debt for less than the full amount due, the ability to seize property before a judgment confirming the amount of the tax debt, or other similar situations involving the judgment of an Executive Branch officer. On the other hand, delegable functions that might be obtained commercially include: providing locator

services to establish a mailing address and phone number for delinquent taxpayers; mailing notices or letters that provide information on the amount of a tax delinquency and payment options; making telephone contacts to remind taxpayers of a delinquency, to provide information on payment options, and to secure intentions of repayment; providing lockbox service for receipt and processing of tax payments; providing data processing services that are performed in conjunction with tax collection activities; research and data gathering; and financial auditing support services. Id.

Further, certain ministerial acts are required under existing law, such as the prompt daily deposit into the Treasury of Federal taxes collected under section 7809 of the Code. This requirement parallels the similar Prompt Deposit Act, 31 U.S.C. § 3302, which generally applies in a non-tax context. The rule of these provisions would, for example, prohibit paying private collectors of Federal tax debts directly out of the amounts they collected. Also, rules related to tort liability, the applicability of state or Federal debt collection practices laws, and of course the taxpayer rights and privacy concerns discussed previously would all have to be examined.

Presumably, Congress can change all of these laws, but we would recommend that a thorough review of the extent of such changes be undertaken before Congress requires the IRS to privatize activities beyond the pilot program.

2. Compensation of private tax debt collectors

As this Subcommittee knows, the first Taxpayer Bill of Rights expressly prohibited the IRS from making compensation or personnel actions (such as evaluations) based on the revenue collected by its agents. See Omnibus Taxpayer Bill of Rights § 6231, Pub. L. No. 100-647, 102 Stat. 3730, 3734 (1988). The Administration supports this approach.

We are aware that contingent compensation arrangements are commonplace in private debt collection agencies. The Administration believes that the compensation for any private debt collection initiative should be subject to the same constraints as are imposed on the IRS. If such a contingent compensation arrangement is not allowable for our own employees, over whom we have supervisory control, why would we permit it for private contractors for whom the rights of citizens may not be the highest priority?

3. Use of appropriated funds

As I have noted, the prompt deposit requirements of existing Federal law would require private collectors of Federal tax debts to be paid with appropriated funds rather than out of the amounts they collected. We believe this restriction is a proper one.

Exceptions to the prompt deposit requirements have been rarely granted, and when they are, Congress closely monitors compliance. For example, in the TBOR 2 legislation recently passed by the House, the IRS was granted the authority to use the income earned in undercover activities to pay additional expenses of such operations. See H.R. 2337 § 1205. However, the authority

was extended only temporarily, and section 7608(c)(4) of the Code, which requires annual reports by the IRS to Congress under this authority, was amended to impose additional reporting requirements with respect to the undercover operations, proceeds, and expenditures. <u>Id.</u>, § 1205(c).

We believe that the general rule of payment only out of appropriated funds should apply to private debt collectors, and other approaches should only be considered after we have more experience.

Refund offset to collect state taxes - H.R. 757

The Internal Revenue Code currently permits the IRS to offset Federal tax refunds in a variety of situations. Section 6402(a) authorizes offsetting Federal tax refunds in order to satisfy other Federal tax debts, and sections 6402(c) and (d) likewise authorize offsetting Federal tax refunds to collect past-due, legally enforceable debts other than delinquent Federal taxes. A taxpayer is entitled to a refund only to the extent that the tax overpayment exceeds these delinquent debts. The IRS thus currently has in place a fourtiered refund offset program, under which the IRS offsets Federal income tax overpayments by, in order of priority, the taxpayer's (1) delinquent Federal tax liabilities, (2) past-due child support obligations which have been assigned to a State under the Social Security Act ("AFDC child support"), (3) delinquent non-tax debts owed to other Federal agencies, most notably defaulted student loans, and (4) past-due child support obligations which have not been assigned to a State ("non-AFDC child support"). Each of these kinds of debts are offset based on a representation from the creditor agency that the debt is valid and enforceable and that certain procedural requirements have been met to ensure due process to the debtor. The IRS does not engage in an independent investigation of the validity of any claim.

H.R. 757 permits Federal tax overpayments to be offset to collect certified State tax debts. In general, the Treasury Department supports this proposal, which will foster and enhance cooperation between the Federal tax authority and State tax administrators. Treasury and the IRS identified some technical issues in the original bill introduced by Mr. Jacobs, involving the priorities for making offsets, the disclosure of tax information, and some other, relatively minor items. These technical problems have been resolved, and we expect the resolutions to be incorporated in the final drafting of the provision.

Some concerns have been expressed that States might ask the Federal government for refund offset of tax debts that are not valid or legitimate. H.R. 757 provides procedural guarantees intended to ensure that this does not occur. We would not support a refund offset provision that would require the Federal government to determine independently the validity of each underlying State tax debt presented to it for collection. Such a requirement would create a burden that would outweigh the benefit of the refund offset program to the Federal government.

Levy on Federal payments

Improving the Government's ability to recover delinquent debts is a priority of the Administration. Last summer, the Administration forwarded to

Congress draft legislation intended to achieve this goal, which was introduced by Representative Horn as H.R. 2234. This legislation will provide enhanced tools to recover delinquent debt owed to the Federal government more efficiently and effectively, while protecting the due process rights of the debtors. H.R. 3019, the Continuing Appropriations for Fiscal Year 1996, as currently pending, contains many debt collection provisions drawn from this bill that do not involve Federal tax debts. I will confine my comments to the tax policy aspects of the Administration initiative.

First, by way of background, Congress has granted the IRS power to collect Federal taxes by levying on "all property or rights to property" of the taxpayer under section 6331 of the Internal Revenue Code. In particular, section 6331(e) permits a "continuous" levy on certain types of regular or continuous payments, such as salaries and wages. This authority permits the IRS to attach all or a portion of such regular payments by serving a single notice of levy on the person making such payments to the taxpayer. Section 6334(a) of the Code grants certain exceptions to the IRS's levy power for specifically enumerated categories of property.

The Administration's debt collection initiative, as reflected in H.R. 2234, contains two changes to the IRS's levy authority. First, this provision would permit a "continuous" levy to be made on certain kinds of non-means tested, recurring Federal payments, while continuing to exempt certain other Federal payments. This proposal, which would not change the kinds of property that the IRS can reach with its levy authority, is essentially a way to reduce paperwork burdens. It would eliminate the need for the IRS to serve repeated notices of levy in order to attach all or a portion of a non-exempt, recurring payment; instead, the IRS could simply serve the notice of levy a single time. Since the continuous levy power is already available to the IRS to collect delinquent taxes from salary and wage payments, we believe that it should also be available to collect delinquent taxes from other kinds of Federal payments, including in particular regular payments to Federal contractors for services provided.

As is now the case, the authority to make a continuous levy on Federal payments would be used only on a case-by-case basis at the discretion of individual revenue officers. As the IRS witnesses here today can explain, the levy procedure is ordinarily a "last resort" for revenue officers to use in the collection process, usually employed only after a taxpayer has ignored repeated notices of the delinquent tax account or has otherwise failed to make adequate payment arrangements. The Administration expects that this will remain the case, and that continuous levy on Federal payments will be used only as one of the last steps to collect unpaid taxes.

The second part of the Administration's proposal would change the exemptions from levy, so that the following non-means tested payments from the Federal government would no longer be exempt: Federal workmen's compensation payments, which are currently exempt under section 6334(a)(7); and annuity or pension payments under the Railroad Retirement Act, and benefits under the Railroad Unemployment Insurance Act, both of which are currently exempt under section 6334(a)(6). We have also recommended a change in the exempt amount of Federal wages, salary, and other income under

sections 6334(a)(9) and 6334(d). Under current procedures, section 6334(d) provides a formula for computing a minimum exempt amount of wages, salaries, or other income received on a weekly basis. Because this formula is complex and unique to each taxpayer, we propose a new and simpler mathematical exemption, under which only up to 15% of Federal salaries or pensions would be subject to levy; in other words, at least 85% of such payments would continue to be exempt.

Congress has always permitted Social Security payments to be subject to levy, and the Administration's proposal would not change current law in this regard. As a practical matter, however, the authority to levy on Social Security is rarely used, and the only intended consequence of this proposal is to reduce paperwork burdens by making such levies continuous.

This legislation will improve collections while providing revenue officers with flexibility to take extraordinary situations into account. As noted above, the levy provisions are generally used only in the final stages of the collection process, after other efforts to collect delinquent taxes have failed. In the event that a levy on non-means tested Federal payments in excess of the exempt amounts were to cause a "significant hardship," the Administration anticipates that the Taxpayer Assistance Order procedure administered by local Problem Resolution Officers under section 7811 of the Code would provide additional relief.

Conclusion

The Administration looks forward to working with this Subcommittee in the future to enhance the collection of Federal tax debts, while protecting taxpayer rights and taxpayer information. In particular, we expect to report to the Subcommittee at the conclusion of the IRS private debt collection pilot project to evaluate the success of that program. Further, we ask that the Subcommittee favorably consider the two specific legislative proposals that I have discussed.

This concludes my testimony. I would be pleased to answer any question that you may have.

Mrs. JOHNSON. Thank you, Ms. Beerbower. Mr. Donelson.

STATEMENT OF JAMES E. DONELSON, CHIEF TAXPAYER SERVICE, ACTING CHIEF COMPLIANCE OFFICER, INTERNAL REVENUE SERVICE; ACCOMPANIED BY RON RHODES, ASSISTANT COMMISSIONER FOR COLLECTION, INTERNAL REVENUE SERVICE

Mr. DONELSON. Madam Chairman and distinguished Members of the Subcommittee, I have a written statement that I request to be entered into the record.

With me today is Ron Rhodes, the Assistant Commissioner for Collection. We appreciate the opportunity to be here to discuss one of IRS' most critical responsibilities, the collection of the Nation's tax revenues. In discussing accounts receivable, it is important to know how IRS' accounts receivable differ from those of private businesses. Specifically, private businesses preapprove the creditworthiness of customers before extending them credit. The IRS makes assessments based on tax laws, regardless of collection potential. Failure to do so would seriously undermine the voluntary tax system and would be unfair to taxpayers who meet their tax obligations.

In the private sector, a liability is established when goods or services are purchased. The IRS must often establish the tax liability through audits. Thus, several years may elapse between the time a tax return is filed or is due to be filed and the time a liability is finally established.

Businesses do not continue to carry debt on their books when it becomes apparent, after attempting to collect, that it will not be paid. By law, the IRS must keep accounts receivables on the books for 10 years, even when we know they are not collectible. Our gross accounts receivable inventory does not only include unpaid taxes, it also includes the ever increasing interest and penalties related to those unpaid taxes.

Thus, unlike accounts receivable in the private sector, the IRS accounts receivable inventory is not a reflection of an annual underpayment of taxes, but it does reflect accounts receivable in the 10-year carryover of unpaid taxes, along with the aforementioned accrued interest and penalties.

At the end of 1995, our gross accounts receivable inventory equaled about \$200 billion of which 28.5 percent or nearly \$57 billion reflected accrued interest and penalties. The gross accounts receivable inventory is divided into two components, those considered currently not collectible and those that are active accounts receivable.

I would like to talk about currently not collectible taxes. Currently not collectible taxes are accounts that a collection employee has determined that cannot be currently collected or paid by the taxpayer. These accounts comprise about \$87.4 billion or nearly one-half of the gross receivable inventory. Accounts in this category are periodically monitored and if a taxpayer is able to pay within the 10-year statute period, the account will be collected so it can move out of the currently not collectible status and back into our active accounts receivable as it is being paid off.

Active accounts receivable are accounts that are potentially collectible and continue to be pursued through activities ranging from notices and telephone contacts, to installment agreements, offers in compromise, and ultimately enforcement actions such as liens, levies, and seizures.

Active accounts receivable comprise \$88.8 billion of the current gross inventory. As early as 1988, the IRS determined that the accounts receivable was a growing concern. Since that time we have continued to take steps to improve the management of the receivable inventory. We have focused on four specific areas.

First, making the composition of the accounts receivable inventory correct. Second, ensuring the accuracy of the assessments that were included in that inventory. Third, improving the currency of the inventory. And fourth, increasing the collection of the amounts in the inventory.

in the inventory.

A number of specifics about what we have done in each of these four areas are covered in my written testimony, but today I want to only mention the results from our efforts to increase collection yield, because I think these results are quite promising.

From 1991 through 1993, collection yield had declined between 4 and 6 percent on an annual basis. Some of that decline was attributable to a decline in staffing. It was also a result of some de-

cline in productivity on our part.

In 1994 our collection yield increased by 3 percent despite a 9.5-percent decrease in staffing. In 1995 we continued to increase our collection yield by over 7 percent. Despite the loss of the compliance initiative in 1996, I am pleased to report that halfway through the year, our collection yield has continued to increase, more than 17 percent over last year for the same period.

Before I conclude though, I would like to touch on two other things very briefly. One, I want to tell you about our efforts regarding contracting out a part of our collection activity, as provided in our 1996 appropriations budget. We intend to award up to 5 contracts and initially deliver approximately 125,000 cases relating to taxpayers who are delinquent in paying their tax obligations.

At this time, we are on schedule to deliver the cases to contractors at the last quarter of fiscal year 1996. Absent any delays in our schedule, an analysis of the results from this pilot project

should be available in the last quarter of fiscal year 1997.

Payments under the contract will be performance based, however, they will not be contingency-fee contracts. Contractors will be given as much freedom as possible while ensuring that they and their employees will be subject to the disclosure laws, the Privacy Act, the Taxpayer Bill of Rights, and applicable sections of the Fair Debt Collection Practices Act.

Information provided to contractors by the IRS or collected by the contractors from taxpayers cannot be used for any purposes other than the fulfillment of the requirements for the awarded contract and cannot be sold or otherwise transferred by the contractor.

We are looking forward to seeing how this pilot project compares to the kind of collection productivity initiatives we have undertaken

The other item I want to mention very briefly is one of the components of the proposed Debt Collection Improvement Acts of 1995—the IRS Levy Program. The IRS Levy Program will enhance our current levy authority on Federal payments and will provide another tool that we can use in appropriate cases to collect taxes that are due.

Currently, in order to levy upon a series of periodic payments, the IRS must serve notices of levy coincidental with each payment. These notices are sent to each Federal employee or payor one at a time or individually. Under the levy procedure in the proposed bill, IRS will send to FMS, the Financial Management Services, a tape to compare FMS' own records and determine if any of the delinquent taxpayers are receiving Federal payments.

If there is a match, FMS will reduce the Federal payment to the taxpayer by a certain percentage that we will work out. The levy will remain in effect and will be continuous until the taxpayer contacts the IRS and makes other arrangements to pay or the taxes

are paid through the reduction of the Federal payments.

This eliminates the need for the IRS to interact with each Federal department or agency individually to determine whether a tax-payer is receiving Federal payments. We believe this is cost effective, saving time for the IRS, as well as for other Federal agencies.

However, this provision, in our opinion, will be most effective in collecting taxes owed from those business taxpayers who are delinquent in paying Social Security and income taxes withheld in trust funds from their employees if these businesses are receiving payments under one or more Federal contracts.

I want to take 1 minute to assure the Subcommittee that if the continuous levy proposal were enacted, the IRS would issue procedures to guard against any automatic levy action upon Social Security benefits. We just don't think that would be appropriate. Our procedures would require a case by case decision before a continuous levy could be used against any Social Security recipient or benefits.

In 1995 we issued approximately 2,000 individual levies against Social Security benefits and did those on a case by case basis, and that contrasted to nearly 2.7 million levies we sent out nationwide.

Taxpayers who are affected by this proposal would be afforded all their rights before a levy is affected against their Federal payments.

Madam Chairman, that concludes my remarks and Mr. Rhodes and I will be happy to answer any questions you might have.

[The prepared statement follows:]

STATEMENT OF JAMES E. DONELSON CHIEF TAXPAYER SERVICE AND ACTING CHIEF COMPLIANCE OFFICER

BEFORE THE SUBCOMMITTEE ON OVERSIGHT HOUSE COMMITTEE ON WAYS AND MEANS

APRIL 25, 1996

Madame Chairman and Distinguished Members of the Subcommittee:

With me today is Ron Rhodes, Assistant Commissioner for Collection. We appreciate the opportunity to be here this morning to discuss one of the Internal Revenue Service's most critical responsibilities — the collection of the nation's tax revenues. You asked that we specifically discuss the composition of the IRS' accounts receivable inventory, and our efforts over the past several years to improve the management and collection of accounts receivable.

April 15th, Tax Day, was just 10 days ago. We recognize that many Americans view paying their taxes as a burden. We are working hard to change this. In fact Madame Chairman, during the last year we have had the opportunity to work with you and Members of this Subcommittee on the Taxpayer Bill of Rights 2 (TBOR 2) and I was pleased to learn that TBOR 2 passed the House. It is particularly relevant in discussing accounts receivable because it is important to remember that the vast majority of Americans pay the taxes they owe on time. Out of fairness to those who meet their tax obligations, the IRS collects overdue taxes from those who do not.

Accounts Receivable

Generally, accounts receivable represent the credit sales of a business. How to handle accounts receivable is an important question for all businesses. One of the most effective accounts receivable management tools is to investigate the credit-worthiness of customers before extending them credit. Private businesses formalize the precise amount and terms of debt repayment when the debt accrues, and they manage their receivables by writing off those accounts that are uncollectible. Businesses do not continue to carry debt on their books when it becomes apparent, after attempting to collect, that it will not be paid.

Like businesses, the IRS has accounts receivable. Unlike private businesses, however, our customers are not purchasing products with their debt, and their credit-worthiness is not determined prior to a transaction.

It is important to understand what makes up the total amount of our accounts receivable inventory. When taxpayers either do not file returns or file inaccurate returns, we make assessments based on the tax laws irrespective of collection potential. Failure to do so would seriously undermine our voluntary tax system and would be unfair to those taxpayers who file timely and accurately. We record these unpaid assessments as accounts receivable and keep them on our books for as long as they are <u>legally</u> collectible. While we attempt to collect these debts, some accounts are obviously uncollectible for various reasons, for example: the taxpayer has died or is insolvent. In other words, we know at the outset that some of these assessments will not be collected.

But our gross accounts receivable inventory does not include only unpaid taxes, it also includes the ever-increasing interest and penalties related to those unpaid taxes. In addition, the law prescribes how long we must keep accounts receivable on the books -- 10 years. Thus, unlike private sector businesses, the IRS' accounts receivable cannot be written off even when we know that they are not collectible. As early as 1988, the IRS determined that accounts receivable were a growing concern, an

assessment both OMB and GAO agreed with. Since 1988, we have continued to take steps to improve the management of the receivables inventory.

Today, I would like to discuss with you our efforts to:

- 1. Determine the correct composition of the accounts receivable inventory;
- Ensure the accuracy of assessments that are included in the inventory;
- 3. Improve the currency of the inventory; and
- Increase the collection of accounts in the inventory.

1. Correct Composition of Accounts Receivable Inventory

In 1990, Congress extended the time the IRS would be required to keep accounts receivable on the books from 6 to 10 years. Thus, unlike accounts receivable in the private sector, the IRS's Accounts Receivable Dollar Inventory ("ARDI") is not a reflection of an annual underpayment of taxes, but includes current receivables, plus a ten year carryover of unpaid taxes, along with accrued interest and penalties.

At the end of FY 1995, IRS' gross accounts receivable inventory equaled \$200 billion of which 28.5% or \$56.9 billion reflected accrued interest and penalties. This is a \$29 billion increase over the FY 1994 balance. A significant portion of this growth was due to additional accruals of interest and penalties, the extension of time we must keep the receivables on the books from 6 to 10 years', and to our non-filer program. The non-filer initiative was started in 1992 to encourage taxpayers who were not filling returns to get back into the system. While we realized the non-filer program would increase our accounts receivable since many were not filing because of an inability to pay their tax obligations in full, we believed it was more important to get taxpayers filing again and then assist them with ways to meet their obligations through installment agreement and offers in compromise options.

The IRS' gross accounts receivable inventory for compliance purposes is divided into two components: Currently Not Collectible and Active Accounts Receivable.

- Currently Not Collectible (CNC) are accounts that a collection employee has determined a taxpayer cannot currently pay. Accounts in this category are periodically monitored, and if a taxpayer is able to pay within the statutory 10-year period, the account will be collected. At the end of FY 1995, \$87.4 billion² or nearly half the gross receivable total is classified as CNC. Of this amount:
 - 37.6% (\$32.8 billion) is accrued penalties and interest.
 - Over 85% (\$75 billion) is not collectible because it is owed by defunct corporations; taxpayers adjudicated bankrupt; hardships; or our inability to locate or contact taxpayers.
- Active Accounts Receivable -- are accounts that are potentially collectible and that continue to be pursued through activities ranging from notices and telephone contacts, to installment agreements and offers in compromise, and ultimately, liens, levies, and seizures. At the end of FY 1995, \$88.8 billion³ is classified in the Active Accounts Receivable category. Of this amount:
 - 41% (\$36.6 billion) the largest portion of the active account has been assigned for enforcement action:

¹FY 1995 was the last year in which the ARDI would automatically increase because of the extension of time we must keep accounts on the books from 6 to 10 years.

²Not included in this balance are Trust Fund Recovery Penalty assessments of \$6.3 billion that are potentially duplicative.

³Not included in this balance are Trust Fund Recovery Penalty assessments of \$8.7 billion that are potentially duplicative and Resolution Trust Corporation assessments of \$9.0 billion that have not yet moved to Currently Not Collectible.

- 22% (\$19.1 billion) of the inventory is awaiting adjudication by a court or acceptance of an offer in compromise;
- 13% (\$11.7 billion) is currently being collected by sending notices to taxpayers;
- 13% (\$11.2 billion) is being collected through installment agreements;
- 2% (\$1.6 billion) is lower value cases that will be substantially collected through systemic monitoring, such as refund offsets and yearly notices to taxpayers.

Included in the \$88.8 billion active accounts receivable is \$18.5 billion of accrued penalties and interest.

2. Ensuring the Accuracy of Assessments Included in Accounts Receivable

There are several ways an account can be put in the accounts receivable inventory. For example, a taxpayer may file a tax return but not pay what is due, and the unpaid tax will be included in accounts receivable inventory. In addition, accounts receivable are created as a result of any number of compliance initiatives. Examinations and secured delinquent returns frequently result in an assessment which is not fully paid, and therefore becomes part of accounts receivable inventory. Tax payments that are erroneously posted may increase the accounts receivable, and we are actively seeking to minimize the erroneous assessments.

Between FY 1992 and FY 1995, the IRS has --

- Through rigorous pre- and post-assessment reviews eliminated \$276 billion of erroneous assessments, preventing these assessments from becoming part of the accounts receivable inventory.
- Created a new computer match that detects discrepancies between the amount taxpayers claimed were deposited and the amount shown in their accounts, an action which has prevented \$22 billion from becoming part of accounts receivable inventory.

Correctly accounting for taxpayers' payments is an important way to prevent the creation of a receivable and the expansion of electronic filing and electronic payments is a significant way to lower our error rate. For example, in FY 1995 taxpayers deposited \$232 billion using the TaxLink/Electronic Funds Transfer Payment System. This was a substantial increase over the \$6.2 billion deposited this way in FY 1994.

Electronic transfer of funds not only means that federal tax deposits are deposited into the Treasury a day earlier than under the paper deposit system, but the errors by taxpayers and us are significantly fewer. As more deposits are received electronically and more returns are filed electronically errors in posting and assessments will continue to decline.

3. Improving the Currency of the Inventory

The earlier a debtor receives a request for payment, the better the likelihood that it will be paid. Recognizing this, we have been working to make the receivables inventory as current as possible. Unlike in the private sector, where liability is established when goods or services are purchased, the IRS often must establish a tax liability through audit. To protect their rights, taxpayers who do not agree with an audit finding may use the administrative appeals process and litigation. Thus, several years may elapse between the time a tax return is due or filed and the time a liability is finally established.

During FY 1995, for example, more than \$17 billion in recommended additional taxes and penalties were not resolved with taxpayers during the examination process. The IRS can not take any collection action until the final liability is determined. Thus, when the FY 1995 recommended assessments finally become eligible for collection and are included in the accounts receivable inventory, several years will have passed.

Once a final determination is made, however, we are moving to contact taxpayers promptly. We are moving to collect tax at the earliest possible time -- by the Taxpayer Service function after account questions are resolved over the telephone or at the close of an agreed audit. During the past 3 years, we have shortened the time between when the delinquency arises and the first telephone contact with the taxpayer is made. Examples of our efforts and the results are:

- Decreasing the number of notices, shortening the notice period, and instituting earlier intervention by telephone. In January 1995, using 770 staff years of the FY 1995 Compliance Initiative in Automated Collection System (ACS) sites early intervention was implemented nationwide. Although the loss of Compliance Initiative funding in FY 1996 will have an impact, the early results of the increase in ACS staffing resulted in additional collections of \$111.2 million.
- Increasing emphasis on payment of agreed tax assessments at the conclusion of an examination. As a result, in FY 1995, Examination secured payment of 64.2% of agreed tax assessments - \$4.4 billion.
- Accelerating the collection of the largest corporate assessments by having the resolution of an issue in one year carried forward to later years without further examination. Under this procedure, taxpayers have agreed to about \$1.1 billion (tax and penalties) for the period FY 1993 through FY 1995.
- Under the FY 1995 Compliance Initiative, we placed 1,727 collection personnel in parts of the country with the most significant workload. Through this targeted placement, in FY 1995, we collected an additional \$545 million in unpaid taxes.
- Expanding installment agreement authority. Installment agreements offer the IRS an opportunity to keep taxpayers in the system who would otherwise not be able to meet their full tax obligations. Expanding the authority increased the dollars secured through installment agreements from \$2.28 billion in FY 1992 to \$5.4 billion in FY 1995.
- Expediting field enforcement action on taxpayers who have repeatedly been delinquent with emphasis on those who are delinquent in their payroll tax payments. A test in one site in 1994 resulted in a reduction to the receivables inventory by almost \$15 million. Nationwide implementation of this program began in FY 1995.
- Expansion of the Integrated Collection System (ICS) (the full automation of the IRS field collection activity) to 2 districts in 1995 and to 7 additional districts in FY 1996. In the two districts with ICS, productivity increased by more than 30% last year. ICS will be fully installed nationwide in FY 1999 and through FY 2004, this initiative alone will result in an additional \$2 billion in revenue collected.

A longer-term initiative that will continue the efforts to improve currency is the integration of our telephone resources by combining the ACS and the Toll-Free Service Center telephone operations. (In FY 1993 we had 70 sites; we currently have 34 sites and our goal is to reduce to 23 sites.) Combining the ACS and Toll-Free sites will give taxpayers "one-stop" resolution of their accounts. It will also provide uniform handling of account issues and allow the IRS to balance outgoing and incoming calls in a way that maximizes the collection of delinquent accounts.

4. Increasing the Collection of Accounts in the Inventory

The initiatives I have just described are designed to ensure the correctness of assessments and accelerate contact with taxpayers so that we collect taxes due without the need for enforcement actions, such as liens, levies, and seizures. I also want to describe our efforts to improve our effectiveness in collecting taxes that are due.

We are changing our business practices, our technology and our organizational structure. Our actions have focused on improving the use of existing collection tools coupled with increased productivity of our field operations. The results are quite promising. For the three years prior to FY 1994, collection yield had declined between 4% and 6%. Although some of this decline was attributable to a decrease in collection staffing, it was also the result of a decline in productivity. In FY 1994, IRS' collection yield increased 3% despite a 9.5% decrease in collection staffing. In FY 1995, collection yield continued to increase by over 7%. While we are making progress, the loss of the Compliance Initiative funding will make it difficult to sustain our increasing collection yield.

Our accounting systems will also significantly improve our ability to collect accounts receivable. We are developing an ARDI expert system. A prototype we will begin using this year will allow us to predict collectibility based on case characteristics.

This system will complement the Inventory Delivery System (IDS) which will be tested in FY 1996. IDS ensures cases are routed to the most effective point in the collection processing stream. These systems prioritize work so it is assigned to the point of most likely resolution as early in the process as possible.

Some additional changes to improve collection already under way include:

- Enhanced cooperation with state taxing authorities. The State Income Tax Levy Program involves agreements with states whereby they accept our levies on state income tax refunds. This resulted in collections of \$108 million from FY 1992 through FY 1994. Another example involves joint collection of delinquent employment taxes which includes joint installment agreements, levies and seizures.
- Proper use of certain collection tools, including installment agreements, offers in compromise, levies, and seizures.
 - In FY 1992, we modified the Offer in Compromise policy and stream lined procedures to enable field personnel to resolve accounts that previously would have languished in the receivables inventory. This resulted in additional collections of \$281 million in FY 1994 and \$295 million in FY 1995
 - Effective use of levies resulted in over \$2.7 billion for FY 1994 and FY 1995.

The improvements we have made in the collection process, that I described earlier, not only helped us increase our collection yield over the last several years but these improvements are also helping us manage the accounts receivable inventory.

Use of Private Collection Agencies

Our FY 1996 appropriation required us to conduct a pilot project to contract out a part of our collection activity. On March 5, we issued the Request for Proposals (RFP) for the pilot. An Amendment to the RFP was issued on March 27. We intend to award up to five contracts and initially deliver approximately 125,000 cases relating to taxpayers who are delinquent in paying their tax obligations. At this time, we are on schedule to deliver cases to contractor(s) the last quarter of FY 1996. Absent any delays in our schedule, analysis of results from the pilot project should be available in the last quarter of FY 1997.

Payments under the contracts will be performance based; however, they will not be contingency fee contracts. Contractors will be given as much freedom as possible, while ensuring that they and their employees will be subject to the disclosure laws, the

Privacy Act, the Taxpayer Bill of Rights and applicable sections of the Fair Debt Collection Practices Act — our own employees are subject to these federal statutes. Information provided to contractors by the IRS or collected by contractors from taxpayers cannot be used for any purposes other than fulfillment of the requirements for the awarded contract and cannot be sold or otherwise transferred by the contractor.

Debt Collection Improvement Act of 1995

One part of the proposed Debt Collection Improvement Act of 1995 – the IRS Levy Program – would enhance our current levy authority on federal payments without infringing on any of the taxpayer protections and rights that currently exist. Furthermore, the proposed IRS Levy Program would provide another tool that we can use, in appropriate cases, to collect taxes that are due.

Currently, before a levy is issued on a federal payment, the IRS must determine what payments or other benefits can be levied and how much money must be exempted from the levy. Then, the IRS prepares a document of levy and sends it to the federal employer/payor. The federal employer/payor must then research the account and prepare another document to send to the Financial Management Service (FMS). FMS then prepares a document so that the levied money is paid to the IRS. In order to levy upon a series of periodic payments, the IRS must serve notices of levy coincidental with each payment.

Under the levy procedure in the proposed bill, the IRS would send to FMS a magnetic tape identifying taxpayers who have failed to pay their taxes after receiving a series of IRS bills, the final notice of intent to levy, and the IRS has attempted to contact the taxpayer. FMS would compare the data on the IRS tape to its own records to determine if any of the delinquent taxpayers are receiving federal payments. If there is a match, FMS would reduce the federal payment to that taxpayer by a certain percentage. The levy would remain in effect until the taxpayer contacts the IRS and makes other arrangements to pay the taxes owed or until the taxes are paid through reduction of the federal payments. FMS would electronically transmit the money to the IRS and the IRS would credit the taxpayer's account with the levied amount. The taxpayer would be notified by FMS that the IRS has levied upon the taxpayer's federal payment and the taxpayer should contact the IRS with any questions.

The proposed levy procedure would apply to certain non-exempt, non-means tested federal payments. A non-means tested federal payment is defined as a federal payment for which eligibility is not based on the income and/or assets of a payee. Payments to federal contractors, annuity and pension payments are within the definition; loan payments are not. The IRS is currently authorized to levy upon Social Security and federal pensions under section 6334 of the Internal Revenue Code.

In addition to Social Security benefits, the proposed levy procedure would allow the IRS to have a "continuous" levy upon annuity or pension payments under the Railroad Retirement Act, benefits under the Railroad Unemployment Insurance Act and workmen's compensation. However, this provision, in our opinion, would be most effective in collecting taxes owed from those business taxpayers who are delinquent in paying over the social security and income taxes withheld from their employees; yet are receiving payments under one or more federal contracts.

The proposed bill eliminates the need for the IRS to interact with each federal department or agency individually to determine whether a taxpayer is receiving payments under a government contract because FMS already interfaces with these agencies as part of its responsibility for issuing checks on their behalf. This is cost effective -- saving time for the IRS, as well as for other Federal agencies.

I want to assure this Subcommittee that if the continuous levy proposal were enacted, the IRS would issue procedures to guard against "automatic" levy action upon

Social Security benefits. These procedures would require a case-by-case decision before a continuous levy could be utilized against Social Security benefits. Taxpayers who are affected by this proposal would be afforded their rights before a levy is affected against their federal payments. Taxpayers would receive the "standard" series of bills and a notice of intent to levy. At any time during this process, taxpayers can contact us to make other arrangements to pay or otherwise resolve the tax matter. Once the taxpayer receives a notice of intent to levy, under our new Taxpayer Bill of Rights II administrative provisions, taxpayers can appeal the levy action. And taxpayers have the right for reconsideration because of significant hardship. Generally, the IRS will release a levy if the taxpayer has a hardship, even if the taxpayer has ignored all previous attempts at resolving the delinquency. Furthermore, if a taxpayer feels that the request for hardship was unfairly denied, a Taxpayer Assistance Order can be filed with the Problem Resolution Office.

Conclusion

I have tried to demonstrate to you and the members of the Subcommittee the priority and significance that the IRS attaches to the collection of revenue through the effective management of the accounts receivable inventory and how the Debt Collection Improvement Act of 1995 would assist us in collecting some accounts in the accounts receivable inventory.

Madame Chairman, that concludes my remarks. Mr. Rhodes and I would be happy to answer any questions.

Mrs. JOHNSON. Thank you very much.

I appreciate your testimony this morning and let me start by asking you about the taxes that are owed that are below the thresholds of the regional offices. It is my understanding each regional office sets its own threshold below which they don't carry on any collection activities. And that this threshold varies considerably throughout the country. Now, first of all, the idea of a threshold varying is fundamentally and, in and of itself, unfair.

In a national system, if there is a threshold, it ought to be uniform in my estimation. It is my understanding that in some areas the threshold is as low as \$5,000 and in other areas it is as high

as \$75,000.

So, I think that is an issue we need to look at here when we talk about tax collection. Are the underthreshold accounts, accounts that we might look at as accounts appropriate to turn over to private collection agencies since we have not been focusing publicly funded resources on that sector and the return is fairly small? Would that be an area in which with some safeguards, contingency fees might be appropriate?

Mr. DONELSON. Madam Chairman, let me address the issue of the below tolerance cases. We have a national standard that establishes in our internal system cases that reach the field or the district offices or the regional offices you referred to. But below a dollar standard which is not a published or a public number, we do have one standard for the whole country and those are generally on the low dollar end of the—

Mrs. JOHNSON. Excuse me, I didn't quite understand you. You do or don't have one standard?

Mr. DONELSON. We do have one, a standard for the entire country that is a low dollar number that we don't publish but we do have one standard.

In addition to that, though, you are correct in that in each district office we establish a queue score which is basically a decision point above which all cases are assigned to collection agents. Those queue scores are assigned based on collection potential, not necessarily dollar amount.

For example, business cases would receive a different score from an individual taxpayer case and different from a trust fund recovery penalty case based on the collection potential as much as the dollar amount. But the dollar amount is a major factor in determining the queue score. Those numbers you have referred to are not necessarily dollar figures but score figures.

But there is a close relevance to the actual dollar amount. You are equally correct to say we have a range in some districts at 5,000 points on the queue score up to 75,000 points in other districts, and that is largely because of the inventory of resources that we have, the people that we have available to work cases. In a situation where a geographical area might have a very bad economical situation occur, such as in California, Mr. Matsui's State, those cases may mount up as people are not able to pay their taxes, and our queue scores in California are generally quite high because they have a disproportionate number of cases there compared to the number of people we have working.

In another State with a low queue score, there may be sufficient resources available and people who are full-time employees, who have got a lower inventory of cases to draw upon. We prefer to have our resources where our cases are but we cannot always control that.

Mrs. JOHNSON. These underthreshold cases generally start out as small liabilities, isn't that correct?

Mr. DONELSON. Not necessarily. The underthreshold cases could be cases where a taxpayer simply didn't file a return. That's why we can't refer to it strictly for dollar amounts because some of the cases are tax delinquency investigations which involve the fact that a taxpayer just didn't file. So, they may have a different or a lower queue score.

Mrs. JOHNSON. So, in what percentage of the threshold cases

does the IRS make an initial attempt to collect?

Mr. Donelson. We make an initial attempt to collect all the cases. They all receive at least one or two notices. The cutting edge difference is that after the notice stream, only cases above the threshold tolerance, or deferred level, are actually sent to our call sites for telephone contact. All cases above tolerance level or deferred level are sent to the call sites and they have at least a call site attempt to collect. After they have gone through our call sites and attempts have been made to collect, anything still remaining goes into our queue system. After the queue system is able to assign a queue score to that, automatically through computerization, the cases reside in our queue.

Depending on the district, as we just discussed, and the resources available, those queue score cases would be assigned. Now, there are exceptions to that. There are some cases on a low dollar level that will be assigned directly to a collection agent because she or he already has cases related to that taxpayer assigned to him. So, a very low dollar case could come through the notice stream, the call site, the queue score system, and be assigned to somebody ahead of a larger dollar case simply because we already have an inventory of cases in the hands of that field agent.

Mrs. JOHNSON. Has there been any discussion of this sector as

a focus of private collection activities?

Mr. Donelson. The sample of cases I referred to in my oral testimony, the 125,000 cases, is made up of a cross section of all types of work. We plan on offering the opportunity for the debt collectors

to work on the very low tolerance cases.

Mrs. JOHNSON. You do, in your testimony, suggest that in some of the new programs they have paid off because you went after a case immediately and there wasn't a long lag time between delinquency and action. One of the advantages of using the private sector where there are small cases involved, or small amounts involved, is that you can avoid lag time, the development of lag time because the agency isn't going to go after small amounts if they can use the same personnel to go after larger amounts.

So, is there some way of accelerating the attention that small amounts get by moving them far more aggressively and rapidly

into a private collection system?

Mr. DONELSON. I think that is one of the things we will find out. I also want to point out that although we declare them below toler-

ance or defer level, 80 percent of those are collected through the statute period. So, we do get that money eventually, and we do get interest and penalties along with that.

But, your point is well taken, that would be an area we would

be very interested in seeing how well this pilot works out.

Mrs. JOHNSON. In the currently not collectible accounts you have some that are not collectible because you can't locate or contact the taxpayers. Again, is this not a group that would be useful to turn over to the private debt collectors?

Mr. DONELSON. Absolutely. It would be an interesting category of cases to see if they can find the people we couldn't find, abso-

lutely.

Mrs. JOHNSON. Thank you.

Mr. Matsui.

Mr. MATSUI. Thank you very much, Madam Chairman.

It has been my understanding and I am trying to understand all this in terms of what the position is of the Service and also the Treasury Department. I know that OMB favors contracting these, sourcing these out to private collectors. I am still trying to understand whether or not Treasury and/or IRS has a position on whether this is a good idea, a bad idea, or whether more funds could ac-

tually do the job in a more effective, efficient way.

In other words, you see, first of all, I want to thank Representative Johnson, her staff, and certainly Chairman Archer for asserting their jurisdiction over this issue because I think it is extremely complex and it requires a great deal of expertise. I think this Subcommittee staff, along with the agencies, have the expertise. Obviously, this has come to us because it was in another Committee's jurisdiction and not taking anything away from the expertise of the other Committee, but this Subcommittee and this Subcommittee's staff have been working on these issues for years.

staff have been working on these issues for years.

This is not the first time we have talked about sourcing out debt collection from the taxpayers. But what I need to know, if it is possible to know this, what is the position of the administration or is there a position that is unified at this time? Because it could very well be it is not because you might have different interests. OMB just wants the increased revenues, obviously, as everyone does, but

your interest may be a little different.

Ms. BEERBOWER. I think, Mr. Matsui, your question is a good one, and the sophistication of this Subcommittee appreciates that one simply cannot take a position on outsourcing Federal tax debt collection. It depends. Is there anything in the collection process that could be appropriately outsourced, as we have gone over and go over, in detail, in the written testimony.

There are a number of nondiscretionary types of functions that could probably be appropriately outsourced, and they do not present the same types of Taxpayer Bill of Rights, safeguards issues, as a total outsourcing of all Federal tax debt collection would

do.

The support of any particular proposal would depend where on the continuum and what types of activities are being outsourced with what restrictions are being imposed on those activities.

The support or opposition of the administration would depend on

the nature of what was being outsourced.

Mr. Matsul. Yes. And see, I guess that is where my problem is, because if you look at what came out of the other Committee, the Government Reform Committee, one will find that there are not any standards on confidentiality and there are no standards in terms of these debt collectors, and, you know, what rules they comply with—State rules, or comply with Federal rules that we would have to promulgate, or the current IRS regulations. No one really knows at this time.

That being the case, I can understand why you cannot take a position. But the issue is, Do you believe you can come up with some safeguards that would allow it, and then what category of taxpayers. As you suggest, there may be some that certainly can be contracted out, but, again, are those easy ones, are those ones you are going to get money for anyway, and are you just going to give a 25- or 30-percent kickback to the debt collector, where then the Service loses money, or they skimmy.

The hard ones, the debt collections may not want and they will not do much work. So there are a lot of facets to this that I am trying to understand.

Ms. Beerbower. Absolutely.

Mr. MATSUI. I cannot seem to grapple with it because I do not know where the center of gravity is in this discussion at this time. But I think it is an important issue, obviously.

Ms. BEERBOWER. But I think it illustrates the great need for care and study before action in this particular area. I mean, clearly, one could study as a legal issue what can be outsourced. Then one could study as a taxpayer rights exercise what safeguards must be in any outsourcing.

Then one could study the economics of the cost benefit of outsourcing this particular activity. Is it cost efficient to do so? And in the end of that study, and certainly the pilot program offers some opportunity to begin this exercise—at the end of it one could conclude that certain kinds of activities meet whatever the criteria are that are established for successful tax debt outsourcing.

Mr. MATSUI. It would be my hope that—and I think what you are saying is entirely reasonable. It would be my hope that the Office of Management and Budget understands the complexities of this, so that they do not immediately throw something out and then all of a sudden we react to it, and then ask you to implement something that is unimplementable.

You see, maybe that is where the discussion has to start, from OMB, because I understand they were the ones who first raised this issue, and then it kind of had a life of its own.

So somebody needs to get to them, so that we can get some help on how we deal with this problem.

Now, we do have the problem of \$200 billion that is uncollectible. Now, I think a further analysis should be done—and again, I am not suggesting we raise more funds for the Service so they can do their job better—but maybe one needs to look at that as—again, you use the word "cost benefit."

What is the most effective way to get this additional debt that is due the government, but is not being collected at this time?

I think we need to ask that question very fundamentally, and maybe that is where it should start before OMB begins to make rash statements, if in fact they are rash.

Let me move over, if I may. Mr. Donelson, you talked about the 125,000 taxpayers you will be seeking through this demonstration program, and I think that is excellent and obviously we look for-

ward to the results of that in 1997.

You indicated there are safeguards. Do you have the safeguards

promulgated yet, regs or rules?

Mr. DONELSON. Yes, Congressman, we have issued an RFP and it has been on the street, and it is now closed, and all the prospective reaction to that is in. So we are going through that process now.

We are well on schedule and should be able, without any delays in our schedule, that are unforeseen, to deliver cases as early as July this year.

Mr. MATSUI. OK. I suppose you will be able to give us some progress reports on this as times goes on.

Mr. DONELSON. Absolutely.

We are in the middle of the competitive procurement. The time for receipt of proposals has closed. The IRS was very pleased to receive more than 30 proposals. We are currently in the advanced stages of evaluating these proposals. Absent any delays, the contract should be awarded in about 2 months.

Mr. MATSUI. Because this obviously is an important issue. Over the years, this issue would come up but I have not thought it through as we are trying to think it through now, and I appreciate this opportunity.

Let me just ask one more, Madam Chairman. If I could just get

into one last area.

In terms of the continuous IRS levies and the \$800 million potential levy on Social Security checks, I understand individuals, because of Social Security overpayments, or whatever the case, I understand that the veterans are not included in this. Right?

There is an exemption for veterans. And then the Social Security

will not kick in until \$9,000. Is that my understanding?

Ms. BEERBOWER. It is my understanding, if you are addressing the debt—I mean, we have some confusion in terms of whether the proposal you are addressing is the one that is in the continuing resolution at the moment, or the original 2234, or whether it was the original administration proposal.

Mr. MATSUI. Does the proposal that is out there now exempt VA? I guess that is the first question I have. Does anyone know that?

Mr. RHODES. Mr. Matsui, I believe they are not exempted under the existing——

Mr. MATSUI. Because of the prior proposal, they are exempt, is that right?

Mr. DONELSON. Right.

Mr. MATSUI. They would not be exempt in this case.

Now, do we have a profile of this \$800 million, how many Social Security recipients will be impacted by this, and then how would you classify them?

Or maybe it is too early yet for that information?

Mr. DONELSON. I think it is too early. That is why in my oral statement, Mr. Matsui, I said that last year we had a little bit less than 2,000 situations where we had to levy. Some of those were the same taxpayer more than one time. We use that with managerial approval. It is not a step we contemplate until we have exhausted all of the levy sources. It is almost a position of last resort for us.

This proposal to have a tape to tape exchange has some dangers that go with that, that we are not going to tread on lightly. We will ask FMS, we envision asking FMS to score the tape, send us back a record, and tell us, "This is who might be getting a payment, do you still want us to do something with them?"

We will engage in some activity on a case by case basis, rather than some kind of an across-the-board action which is more likely

to happen when we exchange a tape on business cases.

So we are going to be extremely careful with Social Security recipients, and we have not worked out all the issues with Veteran's Affairs, because obviously we have certain exceptions, even in today's environment, on paper levies. When we levy, one at a time, there are certain veterans that are exempt from levy on their benefits, and we would not envision going anywhere beyond that, maybe negotiate something less than that now.

Mr. MATSUI. Do you know when you might have the data avail-

able that----

Mr. DONELSON. We will wait and see if the bill passes, and we are working behind the scenes. I do not have a date for you yet.

Mr. MATSUI. OK. I want to thank all three of you.

I hope my comments are not meant to imply that I would not want to see contracting out. It is just that if in fact it should happen, I would hope we would have safeguards both in confidentiality and also standards in terms of collection. Obviously, your agencies will be the ones to have to put those together, and I am very guarded about this, because I would be very concerned, after passing a Taxpayer Bill of Rights, all of a sudden going in the opposite direction.

Because there are a lot of issues, and I do not want to take too much time, but if there is a breach of confidentiality by a collection agency itself, how do we impose enforcement in that situation?

Are there going to be fines, or will there be criminal penalties

against the individual, against the collection agency?

We know what we can do to a Service employee who would do that—firing or whatever it might be—but when you contract it out to an independent contractor, you have a wide variety of issues.

I understand the interest in making sure there is separation, that information from the government cannot be used for other collection.

On the other hand, how do you make sure there is a "fire wall"? We have had that problem with the Bell Atlantic and AT&T on the telecommunications bill, and we still have not quite figured that out.

This is much easier to do if five people are in an office trying to collect money, and they say, "Well, I am getting it from Jim Jones, and what about you?" Why don't you—you know, it is easy to get those records, and I do not know how we deal with this, but we somehow, obviously, need your expertise.

Mr. DONELSON. Congressman, the RFP I think we have submitted to the Subcommittee staff, and will be glad to submit it for the record as well—the RFP outlines the provisions that would guard against any abuses, and what would happen if any abuses occur.

[The RFP and amendment with attachments are being retained

in the Committee's files.]

Mr. MATSUI. Would there be criminal penalties involved if somebody abuses records?

Mr. DONELSON. The same criminal provisions that apply to our agents.

Mr. Matsui. OK.

Mr. DONELSON. Then there will be penalties regarding payment that could be defaulted on the award, if there are abuses.

Mr. Matsul. I appreciate this, and thank all three of you.

Chairman JOHNSON. Mr. Portman.

Mr. Portman. I thank the Chair and I want to thank Mr. Matsui for soliciting the administration's more precise position, and thank you for responding.

I think I understand it better now. That was my primary con-

cern. I have a few specific questions.

The first one has to do with the contingency-fee arrangements. Ms. Beerbower, in your testimony, you acknowledged that in the private sector, often the collection agencies do have an incentive built in which is a contingent arrangement.

You talked about the prompt deposit requirement that all funds collected by Federal agencies must be put in the general revenues,

and so on.

I think that is generally correct. It is my understanding, though, that we also have a statutory exemption, or an exception to the act, which does grant general authority to other agencies, not in tax collection but in debt collection, that permits contingency arrangements.

Without getting into the merits, or demerits of that approach, I wonder why that would not apply equally well to the tax side, as it does to other Federal debt being collected, and to the extent it is used in the private sector, to the extent it makes sense as an incentive, why would it not make sense on the tax side as well?

Ms. BEERBOWER. Well, clearly, Congress can change the law and allow whatever it thinks is appropriate in terms of methods of com-

pensation.

What we discovered in preparing for this hearing is that there is quite a bit of history back in the Taxpayer Bill of Rights I on the evaluation of performance that was based on amounts collected.

At that time—and certainly, one can review that record—Congress was very concerned about the message it sent to collectors, when they were told that their performance depended upon the amounts that were involved.

The suggestion that the amounts involved rewarded the particular all actions and the particular and the suggestion that the amounts involved rewarded the particular and the suggestion that the amounts involved rewarded the particular and the suggestion that the amounts involved rewarded the particular and the suggestion that the suggestion that

lar collectors in particular ways was prohibited by Congress.

So while one could go back and revisit these issues, to determine, first, whether contingencies are appropriate, and second, the method of paying, it would dictate that these particular provisions be changed, were we to outsource Federal tax debt collection.

Mr. PORTMAN. The agency will be wanting to work with Congress, though, to see whether that makes sense. You are indicating we would need a statutory change—I think that is correct—to apply it to tax collection as well as debt collection, generally.

My question is, If we move down the road, as the National Performance Review suggested, as OMB seems to support, and as the department and the agency seem to want to try, at least, with this pilot study, would we want to look at what works in the private sector? That the incentive probably needs to be there.

A second question really goes to Mr. Donelson, and I guess this is just a general question. If you had that \$13 million to spend on

IRS staffing, could you collect more?

Mr. DONELSON. It depends on what more the target is. We esti-

Mr. PORTMAN. More than what you would get from the pilot program?

Mr. DONELSON. We do not know. We have to wait for the pilot program results to come in, but we are anxious to see those results.

Based on our own activity, we would invest that money in upfront collection activity. We would put it probably in our call sites, and based on our performance, we would collect that \$13 million, invest it in salaries and staffing, about \$325 million.

Mr. PORTMAN. What would be the amount collected based on a

\$13 million investment?

Mr. Donelson. About \$325 million.

Mr. PORTMAN. Would that be primarily from the third group, from the queue?

Mr. DONELSON. That would be from the automated collection, the

second phase. After notices, the collection calls.

Mr. PORTMAN. The other question I have, and this is not specifically addressed to the testimony, I know it is difficult to come up with numbers, but the \$200 billion figure is used, and was used in the other Committee of jurisdiction. And others say it is significantly less than that.

Your own data, I think at the IRS, shows that \$63 billion of that represents taxes that may have been assessed, but are not valid receivables, and you talked a little about the difference between the private and the public sector as to how we look at the term ac-

counts receivable.

In particular, you indicate they may really be place markers for compliance actions from nonfilers, so it is not so much taxes that have been assessed, but there is a compliance action underway that would lead to that.

My question is, Do you have a system in place to differentiate between those tax debts and other, what you would consider to be more traditional debts, in the private sector sense of the word?

If you do not have that differentiation, how does it make sense to ask debt collectors, or tax debt collectors to target, and to focus,

where appropriate?

In other words, if the IRS does not have a system in place to differentiate, how are we really going to effectively be able to target and collect?

Mr. DONELSON. First of all, Congressman, the valid/invalid argument is an issue regarding our financial audit and our financial analysis of that already considerable inventory.

In fact we collect or pursue those "invalid" cases because we have no alternative, and oftentimes we have established those, as you imply, through a substitute-for-return process, either for a business or an individual.

We establish that debt in order to create some leverage opportunities for us to get the taxpayer's attention. Oftentimes taxpayers who do not file returns, and just try to drop out of the system, require us to create a return for them, so that we can then pursue them in a collection activity.

In the case of a taxpayer who does not file his income tax return, or his business taxes, we have very little leverage other than to establish an assessment.

After we do that, then we have a lot of leverage, either a seizure, enforcement action, and so forth.

So that is what is characterized, by the way, as an invalid assessment.

Mr. PORTMAN. Let me interrupt for 1 second.

So those invalid assessments would not necessarily be something that a private entity should not pursue?

Mr. DONELSON. That is correct.

Mr. PORTMAN. They are differentiated in—

Mr. DONELSON. But it gets very complicated when the private company perhaps would confront the taxpayer and say you owe x amount of money.

Mr. PORTMAN. When there has not been a formal assessment.

Mr. DONELSON. And the taxpayer would say, No, I do not, here is my return. Then we get into a situation where the inherently governmental aspects of this whole dilemma come to fore. Because we have the——

Mr. PORTMAN. But that can happen in any case.

Mr. DONELSON. It could happen in a "valid" case as well.

Mr. PORTMAN. It could happen whether it was the IRS undertaking the collection activity or whether it was the private collector.

Mr. DONELSON. You are absolutely right. But we have the tools to determine whether or not the taxpayer's claim is correct or not.

Mr. PORTMAN. That gets to some of the privacy concerns Mr. Matsui raised. If you give a private entity a name, address, and an amount owed, it might be appropriate to target them on the so-called valid assessments.

Mr. DONELSON. Valid. Exactly.

Mr. PORTMAN. Thank you very much.

Chairman JOHNSON. In letting the contracts for your pilot project, are all those contracts covered by the Taxpayer Bill of Rights protections and the other protections in the law for the taxpayer? In all those contracts, are those protections guaranteed?

Mr. DONELSON. In the \$13 million pilot, Madam Chairman?

Chairman JOHNSON. Right.

Mr. Donelson. Yes.

Chairman JOHNSON. Has that made it difficult to get interest amongst private collection agencies?

Mr. RHODES. Madam Chairman, I think because of where we are in the procurement process, to comment whether or not we are having difficulty getting bids in might give some information as to whether or not we have had——

Chairman JOHNSON. OK. Right. I thought that might be the case. But we do need to know that, and how soon would we be able to

talk about those things?

Mr. RHODES. Our plans are to award the contract this summer, June to July timeframe. At that point, we would be in a much better position to answer the question.

Chairman JOHNSON. And also about—

Mr. DONELSON. Madam Chairman, if I could just add. Without getting into specific numbers, we have had a very active reaction to this contract proposal, this RFP, and we have had lots of activity and interest in several—more than several. A large number of people——

Chairman JOHNSON. I was just wondering whether those protec-

tions were a sufficient disincentive to participate.

Mr. DONELSON. No, they have not been. Chairman JOHNSON. They clearly are not. Mr. DONELSON. No, they are clearly not.

Chairman JOHNSON. Your lack of ability to guarantee a certain portion of the collections as compensation has also not acted as a disincentive——

Mr. DONELSON. Absolutely not.

Chairman JOHNSON. [continuing]. To the private sector to be in-

terested in this activity. That is helpful.

In the administration's debt collection initiative, which is now in the continuing resolution, it would expand the Federal Government's administrative offset authority to allow for the collection of Federal debts from non-means-tested Federal programs.

The administration exempted the first \$10,000 of Social Security benefits from administrative offset. Yet your IRS continuous levy proposal would allow up to 15 percent of Social Security benefits

to be levied, with no exempt amount.

Why does the administration believe a \$10,000 exemption for Social Security benefits is appropriate for an administrative offset for

other Federal debts, but not in the case of tax debts?

Ms. Beerbower. Well, certainly this Subcommittee is very familiar, there are a number of steps, procedures, investigations, and restrictions that apply to the Internal Revenue Service when it is pursuing its collections, and when there is evidence of hardship.

There are not only requirements, but there are a series of procedures that take place, that will counteract the prompt assessment

or levy in a situation where there is hardship.

The administration is aware of those procedures that the IRS follows and is not concerned about levies being made inappropriately

on people that cannot afford to pay.

In fact the IRS can comment on this, but it is my understanding that in a continuous levy situation, if there were a hardship, that that does not even go, in terms of being submitted for continuous levy, it stays within the Service for other types of collection.

So in the administration's judgment, 15 percent was an easy number for the financial management services people to admin-

ister, and we were not concerned about protecting situations that might be subject to hardship, for all the reasons that I have outlined.

Chairman JOHNSON. I will be interested, when you are done with this round of contracting, incidentally, in what performance standards you do use, since we are not going to use the amount of money collected.

We will be interested in looking at that, when that comes back. On the issue of what it is we are trying to collect, does the IRS need legal authority to report taxes that have not been paid, differently?

It seems reasonable to treat, for example, taxes that have been specifically the subject of negotiation between the government and the private sector and have been specifically agreed as something that will not be pursued, as in some of the S&L agreements, to not include those taxes as part of our collectable taxes.

There are other kinds of liabilities that you include under the general rubric of reportable uncollected taxes, that I think genuinely mislead the public as to whether or not these taxes are collectible.

For instance, the taxes owed by bankrupt individuals or by corporations that are no longer in existence and have no assets.

Has the Service considered rethinking how it reports uncollected taxes?

Mr. DONELSON. Back in 1988, as I mentioned in my oral statement, we started to look at this, and one of the things we did at that time was to slice the accounts receivable into the many components that it is made up of, and we came up with the components you just referred to, and some others.

The whole idea of accounts receivable that is made up of business trust fund taxpayers or corporations, and also of individual responsible officers, which results in a double counting of that, has been included in our discounting to reach this \$200 billion number.

For example, if five people are deemed responsible for not turning trust funds over to us, we set up an assessment in their name, individually.

We carry the assessment on the books for the corporation, even though it is defunct, or out of business; but we have also set up an assessment against the five individuals who we deem responsible, so that we have been able to draw lines of distinction to determine what our accounts receivable truly are. We are able to discount those kind of situations so we do not double count.

The slices we have carved out for uncollectibles, and bankrupted and deceased taxpayers, and so forth, are in our overall uncollectible or currently not collectible part of the accounts receivable, which is also a further delineation of that.

So we have a number of cuts at that to determine what should be measured. However, I think Congress would have to look at a situation where we would agree to a point at which cases would be taken off the books; that is, the statute would not apply, the statutory limitations of 10 years would not apply.

That would be something Congress would have to do.

Chairman Johnson. Well, I would be interested in what categories specifically of dollar amounts ought to be in some other re-

port, because I think one of the reasons people are not very proud of their government is because their government does not provide them very accurate information about what they are doing, or why. I think to suggest to the public that there is 200 billion dollars' worth of uncollected taxes out there every year is to specifically mislead them as to the level of compliance our voluntary system is capable of.

So I am interested in what legal language you would need and what kinds of reports you would recommend in order to get some of the money that clearly is not collectible. We might want to at least know it is there. We may benefit more from a 5 year rather than 10 year collection statute. But I think we need to make some changes in how we talk about our tax debt in order to have a more accurate conversation with the citizens of this Nation.

I would like to have your thoughts on what changes need to be made in that regard, as part of this effort, and the legislation that Mr. Horn is interested in pushing forward.

I thank the panel.

Mr. DONELSON. We would appreciate that opportunity, too,

Madam Chairman.

We are still analyzing the categories of CNC cases where the IRS would recommend a collection statute of less than 10 years. We should be in a position to share our thoughts with the Subcommittee in 30 days.

Chairman JOHNSON. Mr. Matsui.

Mr. Matsui. Thank you, Madam Chairman.

Mr. Donelson, I want to follow up, I think, on the line of ques-

tioning that Chairman Johnson was asking.

There is an x stage process that one goes through with the taxpayer in terms of the collection of debt, first of all, making sure that it is a legitimate debt and then you go through a number of steps, even installment payments, and now through the Taxpayer's Bill of Rights, a waiver of penalties in certain kinds of cases.

Of these 125,000, how did you profile them? I mean, what level?

Did you do it on the basis of years?

In other words, you have up to 10 years, 5 years, and forward. In other words, from 5 to 10 years you would take those debts and throw them in this 125,000. The power of attorney issue, for example, anybody that has a power of attorney, any taxpayer, you have excluded them from this category.

How did you do this? And for example, let us take the latter first, and then maybe you can explain the methodology used in this area.

Mr. Donelson. Well, we have an array of cases, types of cases in this 125,000, and we think we did that for all the right reasons.

We wanted to, first of all, be very much evenhanded in our approach here, so that when we spent this 13 million in a pilot, it would tell us a lot, and we want to know whether the pilot will be effective on the low dollar cases, business cases, individual cases, cases that have been previously examined and deemed to be currently not collectible, as the Chairman said earlier.

Cases where we could not find the taxpayers, or could not locate

their assets. That entire spectrum of cases.

But clearly, we had to stay away from some cases. There would not be an awful lot of sense in giving cases where people are deceased, for example, and those cases that are currently not collectible because of a deceased taxpayer. It does not make any sense to give those kind of cases to the private debt collectors.

But we have a rather robust, I will call it, assembly of cases, or a variety of cases. I will let Mr. Rhodes add some more clarity to

that.

Mr. MATSUI. Let me tell you, the reason I think the methodology is important, because obviously, at the end of the day in 1997, we are going to say, as Mr. Portman asks, "How much did you collect?" And you could play with the numbers.

If you skim, obviously you can have a lot of money collected with the \$13 million, and say, "My God, you know, we collected \$12 billion for a \$13 million investment." But that is if you are skimming. We will not know that unless we understand the methodology.

Or you could just make the very difficult cases that are uncollectible, and say, "Well, we only raised \$10 million through this process." And we say, "Well, geez, that is a waste of \$13 million." We only netted three, or we lost \$3 million. So your methodology is almost going to determine whether this is a good idea or a bad idea.

I suppose we really need to get into this. Probably a hearing process is not a good way to do it. But we do have to understand how this is being done. That is the reason I think this is a critical issue, that perhaps staff to staff should be meeting.

But perhaps Mr. Rhodes could discuss this.

Mr. Rhodes. Well, Mr. Matsui, I think Mr. Donelson said earlier on, and I refer back to that section where he mentioned that we really made an honest attempt to try to build into this test a wide cross section—

Mr. MATSUI. Yes, and I am not suggesting there was any effort to mislead anyone.

Mr. RHODES. I understand.

Mr. Matsul. It is just that that is my concern.

Mr. Rhodes. But, really, by doing that, we feel at the end of the pilot, we will be in a position to fairly evaluate what works and what does not work in the process. I think we can talk much more about that with the Members of this Subcommittee as soon as the contract is awarded.

Mr. Matsui. Thank you.

Chairman JOHNSON. I thank the panel and would like to call now—thank you very much, we look forward to working with you on this—Lynda Willis, the Director of Tax Policy and Administration of the GAO.

Ms. Willis, thank you for being with us today.

STATEMENT OF LYNDA D. WILLIS, DIRECTOR, TAX POLICY AND ADMINISTRATION ISSUES, GENERAL GOVERNMENT DIVISION, U.S. GENERAL ACCOUNTING OFFICE

Ms. WILLIS. Madam Chairman and Members of the Subcommittee, we do have a complete written statement we will submit for the record.

With your permission, I will briefly summarize that statement now.

Chairman JOHNSON. Thank you. I appreciate that.

Ms. WILLIS. We are pleased to be here today to assist in your review of IRS collection practices. Every year, IRS successfully collects over a trillion dollars in taxes, yet at the same time tens of billions more remain unpaid.

My testimony today discusses the debt collection challenges facing IRS and the potential benefits of involving private debt collec-

tors in the tax debt collection process.

A number of longstanding problems have complicated IRS' efforts to collect its accounts receivable. Of foremost concern is the lack of reliable and accurate information on the nature of the debt and the effectiveness of IRS collection tools.

Without reliable information on the accounts they are trying to collect and the taxpayers who owe the debts, IRS agents generally do not know whether they are resolving cases in the most efficient and effective manner and many spend time pursuing invalid and unproductive cases.

IRS also does not have reliable data on the effectiveness of its collection activities and programs. Consequently, it is unable to target its efforts specifically to the taxpayer and the tax debt in question.

IRS is currently trying to capture this data on its Enforcement Revenue Information System and other computerized systems. However, there are questions about the accuracy of the data produced by these systems.

The age of the debts in IRS' accounts receivable inventory is also a problem. IRS' inventory of tax debt includes delinquencies that may be up to 10 years old. As a result, the inventory includes old accounts that may be impossible to collect.

In addition, the age of the receivable does not reflect the additional time it takes for IRS to actually assess the taxes in the first

place.

It may be up to 5 years from the date the tax return is due before IRS assesses the additional taxes. The age factor significantly affects the collectibility of the debt, because as both private and public sector collectors have attested, the older the debt, the more problematic collection becomes.

Another factor relating to the collectibility of tax debts owed by

individuals is source of income.

Taxpayers earning income from nonwage sources, such as pensions, self-employment, and investments are more likely to be delinquent in paying their taxes, and often owe more than wage earners who have their taxes withheld. According to IRS data, 74 percent of its inventory of tax debts owed by individuals is owed by taxpayers whose income was primarily nonwage. The average tax delinquency of these taxpayers was about four times greater than that of wage earners—\$15,800 versus \$3,600.

IRS' collection process is also a problem in that it was introduced decades ago and is generally costly and inefficient. While the private sector emphasizes the use of the telephone, a significant portion of IRS collections resources are in field offices where personal

visits are made.

Updating its computer systems is another challenge facing IRS. Modernized systems could provide IRS collectors with online access to the information they need when they need it. Modernized systems

tems would also help provide the management information needed to evaluate the effectiveness of IRS collection tools, as well as the ability to adopt flexible and innovative collection approaches.

Moving now to the potential benefits of involving private collectors in Federal tax debt collection, we believe these entities offer

the potential for improving IRS debt collection practices.

In May 1993 we recommended IRS test the use of private collectors to support its collection efforts. Many States use private collectors to supplement their own collection programs, thereby taking advantage of private sector capability in managing receivables, gaining access to better technology, or avoiding the expense of hiring permanent staff.

Last month as directed in its 1996 appropriations act, IRS issued a request for proposals from prospective participants in a pilot pri-

vate debt collection program.

Under the pilot, the private collectors are to attempt to first locate and then contact delinquent taxpayers, remind them of their tax debt, and inform them of available alternatives to resolve the outstanding obligation.

An important limitation of the pilot is that the private collectors will not be able to actually collect the taxes owed. Rather, they will facilitate information exchange and contacts between IRS and the taxpayer.

During the pilot, the private collectors will face some of the same

problems in working the pilot cases that IRS employees face.

First, these are not new cases. All will have already gone through much of IRS' collection process, and in some cases, the entire process.

This means in effect the debt may be 10 years old. The cases may also contain some of the other information problems we discussed earlier.

Regardless, the pilot could provide useful insight into the effectiveness of the techniques and technologies used by the private sector.

For example, the pilot calls for 40 percent of the cases to be those in which IRS has been unable to locate or contact the taxpayer.

The remaining 60 percent are cases in which IRS has successfully contacted the taxpayer but has been unsuccessful in securing payment.

To the extent that private collectors can locate, contact, and arrange payment for these cases, the techniques used may be helpful to IRS.

Other useful information could also be obtained on what collection actions are most productive based on the type of case, type of taxpayer, and age of the account.

Using the States experience as an indicator, IRS can expect some additional collections from its proposed pilot, but not necessarily a significant windfall.

In closing, Madam Chairman, IRS faces many challenges in its efforts to improve the management and collection of its accounts receivable.

The key is to find solutions to the underlying causes of the problems that affect IRS' ability to collect delinquent taxes. Solutions will take time because the problems are pervasive and may involve all IRS functions and processes.

As we have previously recommended, IRS needs to develop a detailed and comprehensive long-term plan to deal with the challenges it faces and their interrelationships.

With such a plan, IRS could better assure itself and Congress

that it is on the right track.

Madam Chairman, that concludes my statement. I would be happy to answer any questions you may have.

[The prepared statement follows:]

STATEMENT OF LYNDA D. WILLIS DIRECTOR, TAX POLICY & ADMINISTRATION ISSUES GENERAL ACCOUNTING DIVISION

Madam Chairman and Members of the Subcommittee:

We are pleased to be here today to assist the Subcommittee in its review of the Internal Revenue Service's (IRS) tax debt collection practices. Every year IRS successfully collects over a trillion dollars in taxes owed the government, yet at the same time tens of billions more remain unpaid. As Congress works to balance the federal budget, these unpaid taxes become increasingly important, as do IRS' efforts to collect them.

While most taxpayers voluntarily pay their taxes on time, some are unable or unwilling to do so. It is this latter group whom IRS must deal with in its efforts to collect delinquent taxes. In doing so, IRS faces several significant challenges, including a lack of accurate and reliable information on either the makeup of its accounts receivable or the effectiveness of the collection tools it has at its disposal, as well as receivables that are often years old, out-of-date collection practices, and antiquated technology. It is these problems and challenges--and their results--that led us, the Office of Management and Budget (OMB), and IRS to recognize IRS' accounts receivable as a high-risk area. To address these challenges, significant changes are needed in the way IRS does business, but IRS cannot do it alone.

Recently, the IRS Commissioner has compared IRS to financial service organizations such as banks, credit card companies, and investment firms. Like these organizations, IRS processes data, maintains customer accounts, responds to account questions, and collects money owed. We agree with the Commissioner's functional comparison and believe that, while there are significant differences between IRS and these private sector businesses, IRS may benefit from using private collectors as a part of its portfolio of collecton programs, and it is reasonable to assume that IRS could learn from their best practices as it works to resolve long-standing problems with its debt collection activities.

My testimony today, which is based on past reports and ongoing work, discusses the debt collection challenges facing IRS and the potential benefits of involving private parties in the collection of tax debts.

LONG-STANDING PROBLEMS CONTINUE TO UNDERMINE THE EFFECTIVENESS OF IRS COLLECTION PROGRAMS

A number of long-standing problems have complicated IRS' efforts to collect its accounts receivable. Of foremost concern is the lack of reliable and accurate information on the nature of the debt and the effectiveness of IRS collection tools.

Better Information Needed

Access to current and accurate information on tax debts is essential if IRS is to enhance the effectiveness of its collection tools and programs to optimize productivity, devise alternate collection strategies, and develop programs to help keep taxpayers from becoming delinquent in the first place.

Without reliable information on the accounts they are trying to collect and the taxpayers who owe the debts, IRS agents generally do not know whether they are resolving cases in the most efficient and effective manner, and may spend time pursuing invalid or unproductive cases. Of the approximately \$200 billion currently in the IRS accounts receivable inventory, IRS data shows that approximately \$63 billion represents taxes that, although they have been assessed, may not be valid receivables, but rather are "place markers" for compliance actions.

For example, under IRS procedures, when IRS' information return matching process identifies a taxpayer who received a Form W-2 but did not file a tax return, IRS creates a return for the

taxpayer. Generally, this is done using the standard deduction and single filing status, and often results in the taxpayer owing taxes. IRS then sends balance due notices to the taxpayer reflecting the amount of taxes owed as calculated by IRS--to encourage the taxpayer to file a return with the correct tax amount owed. If the taxpayer does not subsequently file the return, IRS records the amount it calculated as taxes due and generates a receivable. However, when contacted by IRS collection staff, the taxpayer may demonstrate that either no tax or a lesser amount of tax is actually owed. To more efficiently account for and collect money actually owed to the government, IRS would have to be able to differentiate these IRS-calculated accounts from those where there is an acknowledged balance due.

In addition, IRS does not have reliable data on the effectiveness of its collection activities and programs. Consequently, it is unable to target its efforts specifically to the taxpayer and tax debt in question. IRS is currently trying to capture this data on its Enforcement Revenue Information System (ERIS) and other computerized systems. However, IRS has noted in the past that there are questions regarding the accuracy of the data produced by these systems.

Age and Nature of Tax Debts

The age of the debts in IRS' accounts receivable inventory is also problematic. IRS' inventory of tax debt includes delinquent debts that may be up to 10 years old. This is because there is a 10-year statutory collection period, and IRS generally does not write off uncollectible delinquencies until this time period has expired. As a result, the receivables inventory includes old accounts that may be impossible to collect because the taxpayers cannot be located, or are deceased, or the corporations are

Of the over \$200 billion total receivables inventory as of September 30, 1995, IRS data show that about \$38 billion was owed by either deceased taxpayers or defunct corporations. Out of a total of 460 accounts receivable cases that we reviewed in our audit of IRS 1995 financial statements, IRS identified 258 as currently not collectible; 198 of these cases represented defunct corporations, while the remaining 60 cases represented entities that either could not pay or could not be located. These cases represented \$12 billion of the \$26 billion included in accounts greater than \$10 million.

The age of the receivable does not reflect the additional time it took for IRS to actually assess the taxes in the first place. Enforcement tools, such as IRS' matching programs and tax examinations, may take up to 5 years from the date the tax return is due until IRS finally assesses the additional taxes. This reduces the likelihood that the outstanding amounts will be collected.

The age factor significantly affects the collectibility of the debt because, as both private and public sector collectors have attested, the older the debt, the more problematic collection becomes. Because of these and other factors, IRS considers many of the accounts in the inventory to be uncollectible. Specifically, IRS has estimated that only about \$46 billion of the \$200 billion inventory of tax debt as of September 30, 1995, was collectible.

Another factor relating to the collectibility of tax debts owed by individuals is source of income. Taxpayers earning their income from nonwage sources, such as pensions, self-employment, and investments, are more likely to be delinquent in paying their taxes than wage earners who have taxes withheld from their wages. Taxpayers with nonwage income are required to calculate their projected income and make estimated tax payments to IRS during

the year. According to IRS data, the average tax delinquency for taxpayers with primarily nonwage income was about 4 times greater than that for wage earners--\$15,800 versus \$3,600. IRS data also show that, at the end of fiscal year 1995, about \$75 billion, or 74 percent of the \$101 billion in IRS' inventory of tax debts owed by individuals, was owed by taxpayers whose income was primarily nonwage.

Out-Of-Date Collection Processes

IRS' collection process was introduced several decades ago, and although some changes have been made, the process generally is costly and inefficient. The three-stage collection process--computer-generated notices and bills, telephone calls, and personal visits by collection employees--generally takes longer and is more costly than collection processes in the private sector.

While the private sector emphasizes the use of telephone collection calls, a significant portion of IRS' collection resources is allocated to field offices where personal visits are made by revenue officers. IRS has initiated programs and made procedural changes to speed up its collection process, but historically it has been reluctant to reallocate resources from the field to the earlier, more productive collection activities. IRS' fiscal year 1997 budget request states that, although "these [revenue officer] positions still comprise the lion's share of IRS' enforcement efforts, they also represent on the margin the least efficient use of IRS resources." Due to budget cuts, however, IRS is in the process of temporarily reassigning about 300 field staff to telephone collection sites to replace temporary employees who were terminated.

Antiquated Computer Systems

Upgrading its computer systems is another challenge facing IRS. IRS is in the midst of a massive long-term modernization effort—Tax Systems Modernization (TSM)—that if successful would, among other things, help IRS to better collect tax debts by providing its collectors with on-line access to information they need, when they need it. Modernized systems would also help provide the management information needed to evaluate the effectiveness of collection tools and the ability to adopt flexible and innovative collection approaches. Existing IRS computer systems do not provide ready access to needed information and, consequently, do not adequately support modern work processes.

Although TSM is not expected to be completed any time in the near future, IRS has started to automate some collection activities. For example, IRS is currently developing an automated inventory delivery system that is intended to direct accounts, based on internally developed criteria, to the particular collection stage where they can be processed most efficiently and expeditiously. This system, which IRS plans to test in July 1996, is intended to move accounts through the collection process faster and cheaper than under the current system.

Another effort under way involves the automation of certain field collection tasks. These tasks, like many in IRS, have for years involved the manual processing of paper, which has resulted in IRS field collection employees spending significant amounts of time on routine administrative duties. The Integrated Collection System (ICS) is a computer-based information system that is intended to automate some of the labor-intensive tasks performed by field revenue officers. While this effort is not a major technological advancement, it will be a step toward helping IRS employees be more productive by spending their time on more effective and efficient collection-related activities. Basic automation is a given in today's business environment, and if IRS

is to operate like a private-sector business as it says, systems that automate basic work processes are a must.

According to IRS, implementing this system in two pilot districts has resulted in increased collections, faster case closings, and less time spent on each case. IRS employees using the system were also very supportive of it and enthusiastic about its benefits. The system is currently operating in six districts, and IRS plans to roll it out in three additional districts this year. According to IRS, further implementation is dependent on future funding and final measurements of productivity.

POTENTIAL BENEFITS FROM INVOLVING THE PRIVATE SECTOR IN TAX DEBT COLLECTION

Many private and governmental entities are involved in debt collection. We believe that these entities offer the potential for improving IRS debt collection practices. For example, as is being tried currently, there may be a role for private debt collectors in collecting federal tax debt.

Potential Benefits of Using Private Debt Collectors

In response to concern about the persistent nature of IRS' accounts receivable problems, IRS' fiscal year 1996 appropriations legislation contained provisions that earmarked \$13 million for a pilot program to test the use of private law firms and debt collection agencies to help collect delinquent tax

In May 1993, we recommended that IRS test the use of private debt collectors to support its collection efforts.\(^1\) IRS had looked into testing the use of private collectors as early as 1991, but had not carried through with any of its plans.

IRS issued a request for proposals from prospective participants in the pilot program on March 5, 1996. The proposals were due by April 12, 1996, and the pilot is to last 1 year. Under the pilot, the private collectors are to attempt to first locate and then contact delinquent taxpayers, remind them of their tax debt, and inform them of available alternatives to resolve the outstanding obligation.

An important limitation of the pilot is that the private collectors will not be able to actually collect the taxes owed; rather, the intent is for them to facilitate information exchange and contacts between IRS and the taxpayer. There is an OMB policy determination and IRS Office of Chief Counsel guidance that specify that the collection of taxes is an inherently governmental function that must be performed by government employees. Private collectors, however, can perform collection-related activities, such as locating taxpayers and attempting to secure promises to pay.

In addition, the private collectors will face some of the same problems in working the pilot cases that IRS employees face. First, these are not new cases. All will have already gone through much of IRS' collection process, and in some cases, the entire process. This means, in effect, that some of the cases may have been in the accounts receivable inventory for up to 10 years, and some may involve even earlier tax years. The cases

¹Tax Administration: New Delinquent Tax Collection Methods for IRS (GAO/GGD-93-67, May 11, 1993).

²Face-to-face contacts are not allowed.

may also contain some of the other information problems we discussed previously.

The pilot could provide useful insight into the effectiveness of the techniques and technologies used by the private sector in collecting older accounts. For example, the pilot calls for 40 percent of the cases to be those in which IRS has been unable to locate or contact the taxpayer. The remaining 60 percent are cases in which IRS has successfully contacted the taxpayer, but has been unsuccessful in securing payment. To the extent that the private collectors can locate, contact, and arrange for payment on these cases, the techniques used may be helpful to IRS in its efforts to improve its collection programs. The private collectors will be bound by the same taxpayer-rights and disclosure considerations as apply to IRS employees.

Other useful information could also be obtained from the pilot. For example, IRS could learn what actions are most productive based on the type of case, type of taxpayer, and age of the account. For the information to be useful to IRS and Congress in evaluating the pilot, however, the sample of cases must be drawn and the data captured in such a way that the appropriate analyses and tests can be done. We have not analyzed IRS' methodologies for selecting its sample of cases or for evaluating the pilot.

Industry Best Practices May Be Helpful to IRS

IRS faces many challenges in its efforts to improve the management and collection of its accounts receivable. The key is to find solutions to the major problems we previously discussed and their underlying causes that affect IRS' ability to collect more delinquent taxes. Solutions will take time because the problems are pervasive and may involve all IRS functions and processes.

Currently, IRS is making some changes to its collection process as a part of its modernization effort. We reported in the past that private collectors and states that are engaged in collection activities similar to IRS' may provide some best-practice examples for IRS to use in benchmarking its efforts.

Many states use private collectors to supplement their own collection programs, thereby taking advantage of private sector capability in managing receivables, gaining access to better technology, or avoiding the expense of hiring permanent staff. Although many states—including 33 of the 43 states that responded to our survey—have used private collectors, their experiences have varied widely.

A majority of the states that responded to our survey used private collectors to collect delinquent individual income taxes owed by taxpayers residing outside their borders. Of the 28 states responding, 14 said that private collectors were effective in collecting individual income taxes. Regarding other types of taxes, the 12 states expressing an opinion were about evenly split on the effectiveness of private collectors. Using these states' experiences as an indicator, IRS could expect some additional collections from its proposed pilot, but not necessarily a significant windfall. IRS may, however, benefit and learn from the private companies' collection techniques and use of technology.

NEXT STEPS

¹Because all states did not respond to all of our survey questions, our analysis is not necessarily representative of experiences in all states.

IRS faces significant challenges in collecting tax debts. As we have previously recommended, because the problems are pervasive across all IRS activities and processes, IRS needs to develop a detailed and comprehensive long-term plan to deal with the major challenges it faces and their interrelationships. With such a plan, IRS could better assure itself and Congress that it is on the right track and thereby better position itself to obtain the backing and support it needs.

Key to improving IRS' collections of tax debt is the need for upto-date and accurate information as well as modern equipment and technology. IRS also needs to determine the most cost-effective ways to prevent delinquencies from occurring, as well as what it can do in its return, payment, and compliance processes to reduce the number of invalid accounts entering the collection process. To stay competitive in today's business environment, IRS must continually strive to improve collections by testing new and innovative approaches.

Madam Chairman, this concludes my prepared statement. I would be pleased to answer any questions.

^{&#}x27;High-Risk Series: Internal Revenue Service Receivables (GAO/HR-95-6, February 1995).

Chairman JOHNSON. Thank you, Ms. Willis.

Can the IRS not tell us at this time of their delinquent taxpayers, how many have been delinquent for 10 years, 9 years, 8

years, 7 years, 2 years?

Ms. WILLIS. IRS can age the inventory of debt, but it is my understanding that in terms of being able to identify and tell you for specific cases, how old they are in the aggregate, they cannot do that.

Chairman JOHNSON. So they cannot bring up a list of cases that are 3 years old, by taxpayer?

Ms. WILLIS. I do not believe so.

Chairman JOHNSON. That is interesting.

If you were to restructure the presentation of what the uncollectible taxes are in America, would you change the way we do it now?

Do you think there is a case to be made for more clearly identifying tax debt—that is literally, by anyone's standards, uncollectible?

Ms. WILLIS. Yes, Madam Chairman, we do, and that is one of the issues that we get into in our audit of IRS' financial statements, that we think they need to do a better job of segregating out the various components of the debt, so that the Congress and the American public know exactly what is the makeup of the inventory and what parts of it are truly collectible.

Chairman JOHNSON. Would it be helpful if we changed the law, so that that kind of debt could be identified, would have to meet certain standards, and once it met those standards was put into

some other category than uncollected taxes?

Ms. WILLIS. I am not sure how much the law would need to be changed at this point. I think there is an open question on the 10-year rule in terms of how long IRS does, indeed, have to retain that in its inventory, that they have indicated they are going to be look-

ing at.

But I think, without question, we need to do a better job of segregating out what is collectible, what is not collectible, what is a financial receivable, what is a compliance place marker, as I call them in my testimony. And what that will allow us to do is not only better understand what moneys we have, that we can hope to collect, but also better target our efforts to the individual taxpayer and the individual account, which we do not do very well right now.

Chairman JOHNSON. Does the IRS have at its fingertips the number of delinquent taxpayers by region of the Nation? By State?

Ms. WILLIS. Yes, with some variability in terms of whether the taxpayer has a business in one location and lives in another location. Yes.

Chairman JOHNSON. When I suggest taking some of the uncollectible debt off the delinquent tax books, I see a great nervousness develop in those who I have talked to about this idea.

It seems to me, if we do not take it off, we at least need to have a separate account and name we put on it, because it is truly disturbing to have in the category of uncollected taxes, tax liabilities that we, as a government, negotiated with institutions to not collect, to consider as off the boards, and have used that to get people to carry on, take on difficult problems, solve difficult problems in

our society, and move ahead to put themselves in the position of

being tax paying constituents.

So I would be very interested in your thoughts, in some kind of written proposal to us, about what kinds of known liabilities are in the collectible category now or reported as uncollected taxes now.

And how we would get them off the books. I do think we would need a statutory definition of a new category, and some criteria about what it takes to get in that category, or to just wipe them off the books.

The discomfort I have noted is a discomfort with wiping certain liabilities off the books. I think when the government has negotiated a liability away, that liability ought to be gone from the books as well.

There are some other liabilities in here that, for instance, with defunct businesses, where the principals might sometime be in a position to repay some of that debt, and perhaps you would not want to just wipe that off the books.

But I would like some help in rethinking how we report this material, and therefore, how we focus IRS activities and hold them

more accountable.

Ms. WILLIS. Madam Chairman, we would be happy to work with you on that. I think there is going to be a continuum of categories we are going to look at, and a critical part of this is disclosure in terms of what is in that category and its probability of being collected, as you say, whether we have already given up on it, whether we have negotiated a different outcome, so that we understand what is in the inventory, and have a more realistic expectation in terms of what we can collect and what tools we need to be able to collect that debt.

Chairman JOHNSON. I think if we go through this exercise now, as part of this effort to work with Mr. Horn on the legislative initiative that needs to move forward, it is not just Mr. Horn who is interested in this. It is the administration, too.

Ms. WILLIS. Absolutely.

Chairman JOHNSON. A bipartisan effort. That we might also end up needing to provide some resources to the IRS to research certain categories of cases they have now, in order to be clear on exactly what is this problem, and to set up a system whereby in the future delinquent debt would be more accurately, labeled and managed, thereby diminishing the overall problem.

Ms. WILLIS. I also think we would probably want to do outreach to people in the private sector who do debt collection, who categorize accounts, and so forth, to learn from their best practices.

I think they can provide us with a lot of insights into ways of doing business differently than the government has traditionally done so we can learn.

Chairman JOHNSON. Thank you.

Mr. Matsui.

Mr. MATSUI. Thank you, Madam Chairman.

Given the fact that there is an RFP out now by the Service to look at 125,000 returns, and obviously by, I believe it was Mr. Donelson, said by the fourth quarter of 1997 he should have these

results, does it make sense for us to pass legislation now, suggest-

ing contracting out the collection?

Or is this something we should perhaps hold more hearings on, discuss, meet with you, and work with the agencies to see if we can put something together?

I am a little concerned, if we are talking legislatively now, we may be moving a little quicker than we really should be, given the

fact that we do have a pilot program out there.

Could you respond to that, and what your thoughts and recommendations might be on this.

Ms. WILLIS. Congressman, there are a lot of unresolved issues regarding the use of private debt collectors for the collection of Federal tax debt, a lot of which we have discussed here this morning.

GAO recommended in 1993 that we test the use of collectors, and I think testing the use of them is the first step that we need to make.

At the same time we are testing, I think there are other issues we need to study more and look more closely at, possibly before legislation is enacted.

I think one of the questions is the whole question of what is inherently governmental, and whether we need to address that in the

process.

What we are going to do about taxpayer rights. There is a legitimate tension between taxpayer rights and the collection of Federal tax debt. But it is a tension that needs to be addressed in the policy arena in terms of the conditions that we place upon the collection of private debt, and the ways that we use private collectors in collecting tax debt.

Mr. MATSUI. I appreciate what you said. I think you seem to have hit it right on the nose in terms of what is a proper governmental function and what is a function that can be delegated to the

private sector.

I know the States are doing it. Is California one of the States that contract out?

Ms. WILLIS. I believe they are.

Mr. MATSUI. I think I read that some place. I guess we need to, first of all, ask ourselves that question as we are doing these other things as well.

I appreciated your report, which I have not had a chance to read in a great deal of detail, but the need for the Service to try to come up with some long-term goals and get proper data is critical, I

guess, to this entire discussion.

I know it was last year when Commissioner Richardson was before us, and she was discussing some of the steps that needed to be taken, but, you know, bringing a 1920 system into the 21st century, and obviously it is going to take resource, and the whole computer issue and modernization is a very difficult one, and somehow we have to come to grips with it.

I appreciate this. You had one final comment?

Ms. WILLIS. I would just like to say that in a number of cases, the answer to our accounts receivable problems may not rest in the collections function. As I stated earlier, the time it takes to assess the tax debt is a problem in and of itself, and we need to look at this as a part of the entire tax administration system.

As I stated about looking to private entities or lessons learned for best practices, I would highly recommend IRS and Congress also look to the States as we are doing here today.

We do a lot of work looking at State tax administration and there are a lot of fine examples out there of good programs the Federal

Government can learn from.

We think reaching out to those people and learning from our tax

administration peers will make this whole process easier.

I am sure a number of the States have dealt with the issue of taxpayer rights versus collection performance standards, that they could give us the insights of their experience there, and I do not think we would want to lose that empirical evidence as we go through this process.

Mr. MATSUI. Thank you.

Chairman JOHNSON. Thank you.

Mr. Portman.

Mr. PORTMAN. Just briefly, Ms. Willis. Thank you for your testimony again. It is always good to have you before our Subcommittee, and I guess I have two questions, following on your last statement.

I agree with you we need to look at the States, we need to look

at the private sector.

One area that I wonder if you have looked into in the private sector is how collection agencies are successful in the private sector and how that might be applied to using private companies more in our collection efforts on the IRS side. Have you taken a look at that?

Ms. WILLIS. We did a report early in the nineties, I believe 1993, when we looked at different debt collection practices and potential lessons learned for the Federal Government, and we think there are some things there, including the private sector's ability to access newer technology, newer innovative approaches to debt collection.

It was a start. I think there is more work that needs to be done in this area, in terms of looking at what we can learn from the best

practices.

Mr. PORTMAN. But from that you believe the IRS' own collection efforts from getting the private entity involvement could be improved, based on what you have seen in the private sector?

Ms. WILLIS. Yes.

Mr. PORTMAN. The second question is just a more general one. Again, did you spend any time—and I know you are focused on the tax area—but looking at the private collection efforts in other parts of government?

One example would be the Department of Education, student loans, and I know there are other examples where the Federal Government as well as State governments have used private entities

successfully in the collection of debt.

Have you spent any time looking at that?

Ms. WILLIS. No, Mr. Portman, we have not in our group.

Mr. PORTMAN. Has anybody else at GAO looked at that, to your knowledge?

Ms. WILLIS. The justice issue area has looked at the use of private debt collectors in nontax debt, and the pilot that was in the

early nineties, I believe, and I could certainly have them contact you to discuss what they found in terms of nontax debt.

Mr. PORTMAN. I would be interested. I know the other Committee of jurisdiction has some thoughts on that but it would be interest-

ing to get a GAO perspective on it.

And finally, I would just say I hope you will follow the pilot program carefully, and that in 1997, we will have your independent analysis of that program as well.

Ms. WILLIS. We have already been in touch with the Subcommit-

tee staff about doing that, and I assure you we will.

Mr. PORTMAN. Great.

Chairman JOHNSON. Thank you very much, Ms. Willis.

Ms. WILLIS. Thank you.

Chairman JOHNSON. We appreciate your being with us this morning.

The next panel are a number of commissioners from some of our States.

It is my pleasure to welcome Gene Gavin who is the commissioner from the Connecticut Department of Revenue Services, and has provided that department with really extraordinarily refreshing and effective leadership.

Tom Hoatlin, the commissioner of Revenue from the Michigan Bureau of Revenue. Gerald Goldberg, the executive director of the California Franchise Tax Board. Harley Duncan, the executive director of the Federation of Tax Administrators.

Thank you for being with us this morning.

Mr. Matsui.

Mr. Matsui. I would just like to welcome all of the commissioners, but particularly Mr. Goldberg, who is a longtime friend, and somebody that I have worked very closely with, and borrowed his expertise over the years. Welcome to you, Mr. Goldberg, and all of you.

Mr. GOLDBERG. Thank you very much.

Chairman JOHNSON. It is a pleasure to have you here. As so often happens, States experiment more aggressively than the Federal Government really has the right to, and your experience will be very helpful to us as we move forward on this issue.

Mr. Gavin.

STATEMENT OF GENE GAVIN, COMMISSIONER OF REVENUE SERVICES, STATE OF CONNECTICUT, DEPARTMENT OF REVENUE SERVICES

Mr. GAVIN. Good morning, Madam Chairman, Congressman Matsui, and Members of the Subcommittee.

It is an honor for me to have this opportunity to provide testimony in support of H.R. 757 and also to describe, briefly, Connecticut's experience related to tax debt collection.

According to a recent nationwide survey, the number one priority of legitimate, honest taxpayers across the country is to get tax cheats and tax deadbeats onto the tax rolls.

Honest taxpayers know they are shouldering an unfair burden for those who are evading the tax system. And honest taxpayers are angry, with good reason. In Connecticut, we are very serious about leveling the playingfield for all taxpayers, and that is why we see H.R. 757 as an essential tool to reach our goal of increasing voluntary compliance.

H.R. 757 could benefit all taxpayers. It closes loopholes in the tax systems that allow some taxpayers to skirt the laws. It benefits every State with an income tax by bringing in much-needed revenues that are due the State by law.

It is a cost-effective and efficient way of recovering tax moneys due the State when all other efforts to resolve tax debts are exhausted.

H.R. 757 provides a quid pro quo. It reciprocates the program of State offsets for Federal tax debts and can be expected to bring the remaining nonparticipating States into that same arrangement, thus boosting Federal revenues, annually, by \$8 to \$9 million a year.

I remind you that from the 25 States participating in 1994, nearly \$75 million, and that from the 32 States participating in 1995, nearly \$82 million was brought into the Federal tax coffers.

H.R. 757 is a logical next step in the efforts of the IRS and State tax administration agencies to foster cooperative strategies for

greater tax compliance on all levels.

Connecticut has found that offset programs work well within our own State to assure that outside State vendors are current with all tax liabilities, and to assist other State agencies in collecting funds owed. The IRS offset program in Connecticut has come online only recently, and yet in the 2-week period that it has been in existence in Connecticut, Connecticut has already collected \$208,000 on behalf of the Federal Government.

H.R. 757 is framed carefully so that every taxpayer is protected. The offset cannot be made until the State tax agency has exhausted its collection process. After the offset has been made, the taxpayer has the right to appeal the action.

Both State and Federal legislation relating to confidentiality and taxpayer rights assure the States use of offsets cannot be abused.

As a taxpayer myself, I want to see tax deadbeats pay their fair share. No one likes to pay taxes. As commissioner of Revenue Services, I get no discount on taxes in Connecticut. But I abide by the laws that govern every person. I pay my taxes and I have more respect for a government that upholds its laws fairly and conscientiously.

In Connecticut, we give tax compliance and enforcement activities a very high priority and while we are a relatively small State, we think we can be a good example to everyone in the Nation, including the Federal Government.

The three essential elements of our compliance and enforcement program are, number one, a comprehensive internal strategy that focuses on efficient and effective use of personnel and technology.

This alone brings much of the tax revenues due the State with fair and evenhanded treatment of tax debtors, at a cost of about 6 cents per dollar.

Number two, a well-planned program of referring tax debt collection to private collection agencies for those tax bills that we have been unable to collect using our own system.

While the costs of this operation average 20 cents per dollar of tax revenue realized, these are the cases where each dollar brought

in represents a much higher dedication of resources.

Number three, a carefully planned and timed tax amnesty program to bring in sizeable tax debt revenues that are due and owing the State, and to communicate to honest taxpayers and tax deadbeats alike, that we are taking a tough stand on compliance and will enforce the laws at the highest level possible.

Every dollar we brought into Connecticut's coffers during amnesty, over \$44 million, cost us only 2 cents. Amnesty can answer some of the most pressing budgetary problems of governments, and

a Federal amnesty could expect to yield over \$100 billion.

That would certainly help close the Federal budget gap. Amazingly enough, the oldest debt that came in under the 1995 amnesty in Connecticut was one from 1973, 22 years old.

The biggest criticism that has been heard from some State and Federal tax administrators about tax amnesty programs is that

honest taxpayers view it as unfair.

But if amnesty is coupled with the message that all tax and all interest is collected, only penalties are abated, that the tax laws will be enforced, that it is a cost-effective and cost-efficient means to put tax evaders on the tax rolls, that it is an opportunity for tax debtors to pay up and start a clean record, then honest taxpayers have overwhelmingly supported it.

That is what I am hearing, even 5 months after our amnesty pro-

gram ended. As I close, I want to say one more thing.

Much time is being spent in the debate over lowering taxes or raising taxes. I personally and deeply believe, the real question each of us in government as well as every taxpayer should be asking is, Are we doing our very best to properly collect the taxes that are due and owing?

I submit that the answer may be no, and that H.R. 757, and improvements in tax debt collection methods and strategies could well

be that answer.

Thank you very much.

[The prepared statement and attachments follow:]

Testimony of
Gene Gavin
Commissioner of Revenue Services
State of Connecticut
before the
Subcommittee on Oversight
Committee on Ways and Means
United States House of Representatives

Madame Chairwoman and Members of the Subcommittee:

It is an honor for me to have this opportunity to provide testimony to you describing Connecticut's strong support for H.R. 757 as well as our state's experiences related to tax debt collection, particularly as they might be applicable to Federal tax debt collection.

Connecticut, though a relatively small state with a population of 3.3 million, is a microcosm of the nation at large. I point to its broad spectrum of taxes, diversity of population and commerce, its pool of highly trained talent in state administration and strong leadership in state government. I believe that the experience and successful record of Connecticut in its administration of tax collection and compliance can be applied to the much larger scale of the Federal government.

Today, I would specifically like to urge this Subcommittee to recommend strongly the approval of H.R. 757, legislation that would establish a Federal offset program for legally enforceable past due state tax obligations. This legislation would be especially beneficial to participating states by reciprocating the offset programs they currently provide the Federal government for collection of Federal tax debts. Important also is the opportunity for the Federal government to increase its own annual tax debt collections by participation of all the states in the Federal offset program.

First introduced in 1994 with the bipartisan support of 20 cosponsors, H.R. 757 has been reintroduced for this Congress to take action. At no time during the past two years has any opposition been voiced from any Federal official or organization. Connecticut is one of the 32 states and District of Columbia that provide Federal offsets from its state personal income tax refunds. There are 9 income tax states that are not currently participating, but these could be expected to join the offset program if reciprocity were adopted.

Currently, the Federal government may levy on — essentially seize — state income tax refunds to satisfy delinquent Federal tax debts. In those jurisdictions where agreements have been made between the states and IRS, the process is satisfied through the states' own offset programs. States generally do not ask to be compensated by the Federal government for these offsets.

In 1995 alone, states collected \$81.68 million for the Federal government through their refund offset programs. Projections indicate that the Federal government would increase this amount by \$8 to \$9 million annually by participation of the nine states not currently participating. The revenues that states would receive in the early years of this program could be \$150 to \$200 million, an amount that would provide significant tax relief at a time when the states are experiencing budgetary pressures.

H.R. 757 contains all the necessary components to safeguard the Federal government, the states, and the taxpayers:

- it requires the states to notify taxpayers of their obligation and exhaust such other collection measures available prior to referral to the IRS;
- it requires that state tax debts not be satisfied from an offset until all Federal tax debts, past due child support and debts due other Federal agencies are satisfied;
- it authorizes the Secretary of the Treasury to charge the states for the offsets; and

 it amends IRC §6103 to permit the distribution of information regarding offsets to state tax agencies, when necessary.

This measure is of critical importance to the states, particularly as we struggle to improve our services to our citizens and hold the line on taxes. It is also one more way we, who administer the tax statutes, can demonstrate to honest taxpayers that we will pursue tax deadbeats using every avenue available to us.

I have also been asked to describe for you Connecticut's experience with other measures it uses to enhance tax revenue collection.

Connecticut maintains an aggressive revenue collection position. Based on the premise of fairness to honest taxpayers, we also adhere very strictly to Connecticut General Statute §12-39n, The Taxpayer's Bill of Rights (see Attachment A), whose purpose is "...to guarantee that the rights, privacy and property of Connecticut taxpayers are adequately safeguarded and protected during tax assessment, collection and enforcement processes administered under revenue laws of this state."

Three key revenue collection programs have been the focus of the Connecticut Department of Revenue Services ("DRS") in recent years: agency collection and enforcement activities, outsourced collection services and tax amnesty programs.

The Collection & Enforcement ("C & E") Division of the DRS is responsible for the collection of overdue taxes and the enforcement of the state's tax statutes and regulations for those who fail to voluntarily comply. The C & E Division annually manages approximately \$375 million of available accounts receivable, experiences an accounts receivable turnover rate of 73%, case turnover of 60% and maintains an average aged receivable of less than 300 days. The average monthly value of the receivable file is \$101 million, representing approximately 85.000 overdue accounts.

The C & E Division's staffing (approximately 105 employees) has not changed since the passage of a state personal income tax in 1991. Primarily as a direct result of the new personal income tax, which raises approximately \$2.5 billion annually, the C & E Division has experienced a related 30 to 40 percent growth in its collection portfolio. To meet the challenge of this growth while maintaining a zero growth rate in staff, C & E Division management has been creative in the use of personnel resources, new technologies and outsourcing. Internally, development of an automated collection system (see Attachment B-1) and installation of an automated dialing system (see Attachment B-2) have enabled us to increase contacts with overdue tax debtors by 25%. In addition, outsourcing, a direct DRS initiative, also provided for added efficiencies during the 1994-95 fiscal year.

After careful study, C & E Division management had determined that it should utilize independent or private collection agencies to assist in the collection of out-of-state personal income tax debts only. However, recognizing that C & E Division staff resources were stretched to the limit and could be better utilized to pursue large recurring business debts and high risk collections, the role of private collection agencies was expanded. Presently, all cases related to personal income tax debts, both in and out of state, are candidates for referral. Using its automated collection management system, the C & E Division prescreens and evaluates accounts for referral to collection agencies based on certain threshold system settings. Periodic adjustments are made to the threshold settings based on the C & E Division's work flow and relative ease to collect.

Prior to a case being assigned to a private collection agency, it follows a route through our internal system that entails a series of collection letters and phone contacts. When it is determined that we will not be able to collect the tax debt through our usual methods (bills, levy notices or tax warrants), it is referred to an outside agency. During the first full year of outsourcing (1994-1995 fiscal year), 3,550 accounts with an associated value of \$2.04 million v ere referred to independent collection agencies. Of these referrals, \$327,000 was collected and 484 (13.6 percent of the cases referred) cases were resolved. Based on our first year's experience with outsourcing collections and the general difficulty of cases referred, DRS was pleased with these results. As discussed below, our record was even more successful in the second year of outsourcing, which is still underway.

Thresholds for collection agency referrals are continually reviewed and revised to accommodate the elasticity of our portfolio. Connecticut's growth of its receivable file during

the past three years is directly attributed to the initiation of a state personal income tax in 1991, as mentioned above, and the general economic decline in the Northeast. During fiscal 1995-96, we have already referred to collection agencies 11,900 accounts with a value of \$9.2 million. To date, approximately \$1.4 million (about 15 percent of the value referred) has been credited and 3,300 cases (about 28 percent of the cases referred) were closed. Customer service-related problems, skip tracing and/or legal action which must be performed on these accounts are handled by DRS.

The C & E Division currently has a budget of \$180,000 for outsourced collection services. Contracts are written with individual vendors who are awarded contracts based on the state's bidding process. Currently, all revenues collected by these outside vendor collection agencies are remitted to the Department and the vendors submit bills for their services that are contracted at 15 to 23 percent of gross revenues collected.

Based upon the early success of the program, expansion of outsourcing for Connecticut's tax debt collection is continuously being evaluated. Currently, 10 percent of our case file, or 8,600 accounts, has been assigned to private collection agencies. The cost per dollar of revenue realized from outsourcing, at an average of \$20 per dollar, compares to our C & E Division's average cost of collection of \$.06.

Tax amnesty programs, by their definition, are limited in use. However, Connecticut's two such programs have proven to be highly successful supporting the state's tax debt collection strategy. Connecticut and 34 other states have raised well over \$1.5 billion in additional revenues by using amnesty (e.g., penalty waiver and promise of no civil or criminal prosecution) as the incentive. Connecticut alone, a relatively small state, has collected over \$100 million in back taxes during two amnesty programs, held five years apart. We have found that economic incentives sometimes produce better results than threats of enforcement actions. Private business has long recognized this principle.

Amnesty can offer dramatic results by turning the tax agency's accounts receivable file into cash and in adding new taxpayers to the rolls. Connecticut's experience is that in each of the amnesty programs, approximately 52 percent of the filers seeking amnesty were already known to us. While the argument has been made that these accounts would eventually be recovered, it is important to realize that minimal resources were expended to bring those revenues in during amnesty.

Amnesty also provides a cost efficient alternative to traditional collection procedures. Our own state's most recent amnesty program resulted in over \$44 million in revenues, of which \$19.6 million were accounts receivable known to our agency. If we had used other collection procedures available to us to bring in those same dollars, the C & E Division would have had to expend close to 58,500 staff hours and a conservative minimum expenditure for personnel alone of \$906,000. While it would be virtually impossible for any agency to deploy the resources to accomplish this level of collection in three months, the successful marketing and advertising of an amnesty program leverages available dollars with substantial benefits.

Our experience has been that honest taxpayers want tax cheats to be found and placed on the tax rolls. Honest taxpayers know they are subsidizing the tax deadbeats and they are becoming more angry and increasingly vocal about it. Amnesty brings in both tax debtors known and unknown to the tax agency, as well as those who have underreported tax liabilities. With those taxpayers being identified, and the accounts receivable portfolio being turned over faster, collection efforts can be focused more intensively on the more difficult and complex cases.

Because of the short term nature of amnesty programs, costs can be closely controlled. During Connecticut's 1995 Amnesty, no additional personnel were added and existing resources were redeployed to its support. Each dollar realized cost Connecticut \$.02 to raise — a sure win for all citizens in the state.

Amnesty programs work best when they are integrated with effective programs to improve voluntary compliance and enforcement. The long term results are expanded taxpayer rolls, increased turnover of the inventory of accounts receivable and a higher overall level of voluntary compliance.

The implications are overwhelmingly in favor of a Federal tax amnesty at this time. A poor Federal tax compliance rate has become recognized as fact. The collection gap has been

growing at astronomical rates over the past five years. The General Accounting Office ("GAO") has published data that demonstrates that the gross inventory of Federal tax debt — (i.e., monies known to be owed by specific tax delinquents, but not collected) grew from \$87 billion to \$156 billion — about 80 percent — between 1990 and 1994. At the same time, the IRS annual collection of delinquent taxes has declined from \$25.5 billion to \$23.5 billion — about an 8 percent decrease — since 1990. (see Attachment C — Federal Tax Amnesty — Budget Gridlock Buster, by Gene Gavin)

Lack of enforcement of tax laws at the Federal level has become common knowledge (see Attachment D — "Millions fail to file taxes," by Ralph Vartabedian, Los Angeles Times (copyright), April 14, 1996). Failing to file Federal income taxes is endemic across all income levels. By its own accounting, the IRS acknowledges that over 300 attorneys in New York City alone failed to file Federal income tax returns. And it estimates conservatively that at least 6.5 million Americans are nonfilers. Yet the IRS has consistently failed to acknowledge its endemic problems. Despite data from GAO to the contrary, the IRS maintains the same stance in 1996 as it did in 1990, that its enforcement is effective and its methods are the best ones available (see Attachment E — correspondence to Commissioner Gene Gavin from U.S. Treasury Office, Lowell Dworin, Director, Office of Tax Analysis, dated March 29, 1996).

Clearly, there is need to take strong corrective action on reducing the Federal collection gap. The IRS has been given funding to develop a comprehensive and aggressive compliance and enforcement program called "Compliance 2000." The timing for a Federal amnesty could not be better. The potential for raising over \$125 billion from accounts receivable files and the millions of nonfilers and underreporters of Federal taxes is very real. A one-time Federal amnesty would bring us a long way toward reducing the budget gap that is on everyone's minds, holding the line on taxes while maintaining the social service support that is being demanded and contributing to lowering the national debt (see Attachment F – "Tax amnesty and the federal budget", Editorial, *The Advocate*, January 23, 1996).

In closing, I would like to make the following points relative to cost effective and cost efficient tax administration. At every level of government, we are spending considerable time in debate over whether to lower taxes or raise taxes. I firmly believe that the real question each of us should be asking is, "are we collecting taxes that are due and owing properly?"

And I further contend that if we are doing everything in our power to collect the taxes properly, we <u>can</u> hold the line on taxes — yes, we can even <u>reduce</u> taxes, when <u>all</u> taxpayers are paying their fair share.

Therefore, I urge you to give consideration to developing opportunities to bring in all tax delinquents, at all levels, through a carefully framed plan of a Federal amnesty, followed closely by stepped up enforcement of the tax laws at all levels, and the use of private collection services when deemed appropriate for effective and efficient collections portfolio management.

Further, I recommend that you reciprocate the service that the states provide the Federal government through their refund offset programs by taking immediate actions that will assure passage of H.R. 757.

This concludes my formal statement. Thank you for the honor of speaking to you today. I will be happy to answer any questions.

Gene Gavin

Commissioner of Revenue Services

State of Connecticut

ATTACHMENT A

- Sec. 12-39n. Taxpayer's Bill of Rights. There is created a Connecticut Taxpayer's Bill of Rights to guarantee that the rights, privacy, and property of Connecticut taxpayers are adequately safeguarded and protected during tax assessment, collection and enforcement processes administered under the revenue laws of this state. The rights afforded taxpayers to assure that their privacy and property are safeguarded and protected during tax assessment and collection are available only insofar as they are implemented in other parts of the general statutes or rules or regulations of the department of revenue services. The rights so guaranteed Connecticut taxpayers in the general statutes and the departmental rules and regulations are:
- (1) The right to available information and prompt, accurate responses to questions and requests for tax assistance.
- ·(2) The right to request assistance from a taxpayer's rights advocate of the department, who shall be responsible for facilitating the resolution of taxpayer complaints and problems not resolved through the normal administrative channels within the department, including any taxpayer complaints regarding unsatisfactory treatment by department employees.
- (3) The right to be represented or advised by counsel or other qualified representatives at any time in administrative interactions with the department and the right to have audits, inspection of records and interviews conducted at reasonable times and places.
- (4) The right to obtain simple, nontechnical statements which explain the procedures, remedies, and rights available during audit, appeals, and collection proceedings, including, but not limited to, the rights pursuant to this Taxpayer's Bill of Rights and the right to be provided with a narrative description which explains the basis of audit changes, proposed assessments, assessments and denials of refunds; identifies any amount of tax, interest or penalty due; and states the consequences of the taxpayer's failure to comply with the notice.
- (5) The right to be informed of impending collection actions which require sale or seizure of property or freezing of assets, except jeopardy assessments, and the right to at least thirty days' notice in which to pay the liability or seek further review.
- (6) The right to have all other collection actions attempted before a jeopardy assessment unless delay will endanger collection and, after a jeopardy assessment, the right to have an immediate review of the jeopardy assessment.
- (7) The right to seek review, through formal or informal proceedings, of any adverse decisions relating to determinations in the audit or collections process.
- (8) The right to have the taxpayer's tax information kept confidential unless otherwise specified by law.
- (9) The right to procedures for requesting cancellation, release or modification of liens filed by the department and for requesting that any lien which is filed in error be so noted on the lien cancellation filed by the department, in public notice and in notice to any credit agency at the taxpayer's request.
- (10) The right to procedures which assure that the individual employees of the department are not paid, evaluated or promoted on the basis of the amount of assessments or collections from taxpayers.
- (11) The right to have the department begin and complete its audits in a timely and expeditious manner after notification of intent to audit.

(May Sp. Sess. P.A. 94-4, S. 67, 85.) History: May Sp. Sess. P.A. 94-4, S. 67 effective June 9, 1994.

ATTACHMENT B

Attachment B-1

AUTOMATED COLLECTION SYSTEM

A computer assisted case management system which supports the Department's collection and compliance programs. Several important components of the Automated Collection System (ACS) are as follows:

- · electronic routing of overdue tax data from DRS accounting system
- risk management assessment of collection portfolio via table settings
- electronic capture of collection history... contacts, promises, payment plan info
- automated notice and letter generation based on management settings
- · electronic tracking of promises, dates and critical events
- aids in organizing work parameters . . . time and day when collectors make phone calls or perform research related functions
- electronic repository for bankruptcy filings, liens, levy notices and the related management tracking of these activities
- track historical collection data to help prioritize similar or same accounts for future follow-up
- provide appropriate management reports on collection activity

Attachment B-2

AUTOMATED DIALING SYSTEM

The Automated Dialing System is a computerized intelligent dialing system which complements the DRS Automated Collection System and helps maximize the number of outbound telephone contacts for overdue tax debtors. Several important features of this system are:

- automatically controls call queuing / dialing / screening so collectors can communicate throughout the day with maximum efficiency
- screens out answering machines, no answers and busy signals
- schedules recalls automatically
- passes live contacts and screens of data immediately and simultaneously to collectors
- provides on-line record updating with automatic updating of user-specific fields
- brings numbers in different time zones into the calling list automatically at correct time
- automatically adjusts calling rate to the external environments of each job and to collectors signing off and joining jobs
- provides system job control and monitoring for maximum management control of outbound calling
- provides for prioritization of individual call jobs based on management goals
- monitor collector performance from station to station
- provides all level of management reports . . . individual operator performance and exception reports

ATTACHMENT C



STATE OF CONNECTICUT

DEPARTMENT OF REVENUE SERVICES

March, 1996

FEDERAL TAX AMNESTY BUDGET GRIDLOCK BUSTER

Congress and President Clinton continue to grapple with ways to eliminate the federal deficit and balance the federal budget. They have not yet considered a nationwide federal tax amnesty program. They should.

On a state level, tax amnesty programs have proved to be a powerful tool to address budget deficits and convert accounts receivable into cash, quickly and efficiently. Connecticut and 34 other states have raised well over \$1.5 billion in additional and unanticipated revenues through this means. Connecticut alone, a state with a population of 3.3 million people, has collected over \$100 million in back taxes during its amnesty programs.

The Internal Revenue Service (IRS) estimates that its "tax gap" (i.e., the difference between what taxpayers owe and what they voluntarily pay) is approximately 17 percent of total federal income taxes due each year. This amounts to more than \$100 billion in federal taxes unpaid by nonfilers and under-reporters. Obviously, more than \$100 billion could go a long way to help resolve the current federal budget impasse. Additional and unanticipated revenues of over \$100 billion could allow both tax cuts and reasonable Medicare savings — the two biggest areas of controversy in the current budget debate.

In addition to the tax gap, the IRS suffers from a "collection gap." Over the period 1990 through 1994, the gross inventory of federal tax debt, including accounts receivable (i.e., monies known to be owed by specific tax delinquents, but not collected) grew about 80 percent — from \$87 billion to \$156 billion. At the same time, the IRS annual collection of delinquent taxes has declined from \$25.5 billion to \$23.5 billion — a decline of approximately 8 percent since 1990. Thus, the "collection gap" has been growing.

It has been suggested that the growth in accounts receivable may, in part, be attributable to the ineffective management of the receivables file. According to the General Accounting Office (GAO), IRS efforts to collect tens of billions of dollars in its accounts receivable file have been inefficient and unbalanced. The management of the IRS accounts receivable file has been hampered by both self-imposed and external constraints. The IRS has generally followed a lengthy and rigid three-stage process that begins with a series of written notices, or bills, sent to delinquent taxpayers over a period of about six months, followed by telephone calls; it ends with visits to delinquent taxpayers. As a result, the IRS management of accounts receivable has been recognized by GAO, the Office of Management and Budget and even IRS management itself, as a high-risk area. Tax amnesty can be the "carrot" that encourages these same taxpayers to come in on their own accord, thus saving the expense incurred with multiple contacts and generating much needed revenues to support government operations.

What is tax amnesty? In general, tax amnesty is a limited period of time (e.g., 90 days) during which individuals and businesses can come forward voluntarily to pay their back taxes and related interest without penalty or fear of civil or criminal prosecution, and possibly obtain a reduced interest rate. Tax amnesty programs have never involved abatement of the underlying tax liability. Nearly every amnesty program has included accounts receivable in their programs. As a matter of good tax policy, amnesty should be part of a more broadly gauged program to improve voluntary compliance and strengthen tax enforcement. If tax amnesty is the "carrot," then new penalties and/or stronger enforcement practices must be the "stick" once the amnesty program ends.

Who would benefit from a federal tax amnesty? All taxpayers and citizens would benefit, not just the people and businesses who owe back taxes and come in under amnesty. Under a federal an nesty program, Washington would get much of the money it is due and could use it to balance the budget, pay for services and/or assist in cutting taxes for all taxpayers.

The IRS is currently well-positioned to launch its first-ever amnesty program. Recognizing its poor compliance rate (i.e., 83 percent), the IRS is presently engaged in "Compliance 2000," a program designed to improve the federal tax compliance rate to 90 percent by the year 2000. It is modernizing its computer and information technologies, working more closely with state tax agencies and instituting more taxpayer-friendly initiatives, such as the touchtone telephone filing system.

Federal Tax Amnesty by Gene Gavin

March, 1996

A federal tax amnesty program, supported by a well-publicized advertising and marketing campaign, would enhance the ability of the IRS to reach, perhaps exceed, its 90 percent compliance goal by:

- · conveying an image to the public of the IRS as being responsive to complying taxpayers;
- · heightening public awareness of federal tax laws to increase voluntary compliance;
- · adding new tax filers to the federal revenue base for the long term; and
- communicating to the public the enhanced ability of the IRS to take a more assertive
 enforcement and collection posture against fewer tax cheats and deadbeats.

Some will be opposed to a federal tax amnesty program because it may be viewed as being unfair to honest taxpayers. Individuals and businesses who pay their taxes on time and/or fully comply with the tax laws are sometimes skeptical about amnesty programs. They see tax amnesty as an undeserved break for tax cheats and tax deadbeats.

However, as an honest taxpayer and one who pays his fair share of taxes, I do not share this view for the following reasons:

- legitimate taxpayers are currently subsidizing tax cheats and deadbeats, and that is patently
 unfair to the "good guys":
- it takes a great deal of taxpayer money for the IRS to not only uncover the "bad guys," but also to collect what is owed, once detected. As such, an amnesty program may be a cost effective way to perform an audit and collection function;
- tax amnesties do not reward the "bad guys" because the programs do not abate taxes and rarely
 abate interest:
- the waiver of civil and criminal penalties may be a small price to pay, particularly with nonfilers and under-reporters, since they have been previously undetected and, unfortunately, may never be detected.
- nonfilers and under-reporters who come in under amnesty not only produce a financial
 windfall in the year of amnesty, but also produce a steady stream of new revenues in the future
 as they join the tax rolls with the other "good guys"; and
- the information obtained through nonfilers and under-reporters under amnesty can be used to develop profiles and audit programs which, in turn, can enhance the detection of similar individuals and businesses in the future.

While a greater burden of justification exists for extending amnesty benefits to known tax delinquents (i.e., accounts receivable), a strong case can be made for inclusion on the federal level. According to a study conducted by the Federation of Tax Administrators (an association of all state tax agencies across the country), the inclusion of accounts receivable within the terms of amnesty generated considerably more revenue, both in absolute and relative terms, than did state programs limited to nonfilers and under-reporters. Connecticut, for example, collected approximately 25 percent more of its delinquent accounts as a result of tax amnesty. Since the IRS has recognized its inability to effectively manage its receivables file in the past, the inclusion of this category of tax delinquents would make a significant positive impact on the revenues collected under a federal tax amnesty. Furthermore, an aggressive enforcement campaign after the amnesty program could enhance future taxpayer compliance by eliminating the current impression that the IRS is neither fair nor serious about collecting overdue taxes.

Based on all the information available nationwide, a well-planned federal tax amnesty program could easily generate revenues exceeding \$125 billion. That is something worth talking about. Are you listening, Washington? I hope so! After all, 35 states can't be wrong.

Gene Gavin, C.P.A., M.B.A., J.D., LL.M., is Commissioner of Revenue Services for the State of Connecticut

ATTACHMENT D

IGB

Millions fail to file taxes

■ IRS knows it:

Yet few scofflaws suffer consequences.

By Raiph Vartabedian Los Angeles Times

By Raiph Vertabeden

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Hughes was known sevoud Some
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Littury to federal charges but was
sentenced to just 36 months probation, and today be is again practicing tax law.

Although the IRS has a reputation as a pit bull when it comes to

INSIDE Tax precreet traders have until Treeday See Page AS

Page A8 New Haven Register, Sunday, April 14, 1996

CONTINUED FROM THE FRONT PAGE

Taxes: Penalties often fail to deter

Continued from Page A1

vaviol filing tax returns without running afoul of the IRS for years at a time?

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ATTACHMENT E



DEPARTMENT OF THE TREASURY WASHINGTON

MAR 2 9 1996

Mr. Gene Gavin Commissioner State of Connecticut Department of Revenue Services Twenty-Five Sigourney Street Hartford, CT 06106

Dear Mr. Gavin:

Thank you for your letter of February 9, 1996 to Secretary Rubin suggesting a Federal tax amnesty program. Your letter was referred to this office because it concerns a matter of tax policy.

We do not believe that a Federal tax amnesty program would generate a significant amount of net tax revenue. A Federal tax amnesty would be unlikely to be as effective as state amnesty programs, since the most successful state amnesties coupled amnesty with increased enforcement efforts that are already a part of the Federal tax program. Moreover, state amnesties have often been deemed to be successful because of their production of gross tax revenues. Where further analysis has been undertaken, there are indications that even successful state programs merely accelerate the collection of taxes that would have been collected anyway, so that net amnesty returns are very modest. For your information, we have enclosed testimony on this subject presented in July of 1990 by Michael J. Graetz, former Deputy Assistant Secretary (Tax Policy).

Thank you again for writing Secretary Rubin.

Sincerely,

Lowell Dworin

Director, Office of Tax Analysis

Enclosure

For Release Upon Delivery Expected at 1 p.m. July 25, 1990

STATEMENT OF STATEMENT OF HICHAEL J. GRAETZ DEPUTY ASSISTANT SECRETARY (TAX POLICY) DEPARTMENT OF THE TREASURY BEFORE THE SUBCOMMITTEE ON COMMERCE, CONSUMER AND MONETARY AFFAIRS COMMITTEE ON GOVERNMENT OPERATIONS UNITED STATES BOUSE OF REPRESENTATIVES

Mr. Chairman and Members of the Subcommittee:

I am pleased to have this opportunity to present the views of the Treasury Department on the advisability of a Federal tax amnesty program.

The views we shall express here today are necessarily of a general nature. As you know, current interest in a Federal tax amnesty has been spatked largely by the widespread experience during the last decade of state tax amnesty programs. These programs, however, have been as varied as the states that conprograms, how ducted them.

There is no specific amnesty proposal before this Committee for consideration. Our testimony focuses primarily on a potential Federal tax amnesty program under which certain penalties would be waived for taxpayers who admit voluntarily to failing pay the correct amount of tax in the past and who pay the full amount of the unpaid tax, including interest due.

We believe that such a general Federal tax amnesty program would be unvise. First, contrary to certain extravagent claims, we do not believe a Federal amnesty program would raise large additional revenues, and there is a risk that such a program, in fact, might lose revenue. Most states did not have effective income tax enforcement systems in place when their amnesty programs were instituted, and those state amnesty programs that have been most successful in raising revenue generally were coupled with increased enforcement efforts -- enforcement efforts that

already are a part of the Federal tax system. The Treasury Department is also concerned about the actual and perceived fair-ness of a Federal amnesty program, as well as about the possible adverse effects of an amnesty on taxpayer morale and compliance.

Carefully targeted relief from tax penalties for taxpayers who step forward to pay unpaid or understated taxes might be desirable in some cases, but only if such relief is linked with significant, additional enforcement programs, such as new withholding requirements. We caution, however, that even before targeted relief is provided, Congress should carefully consider the trade-off between collecting unpaid taxes, on the one hand, and the potential for damage to the voluntary compliance system, on the other hand.

Hy testimony today has three parts. First, I shell describe briefly the experiences of the states with amnesty programs. Second I will be that the state and Second I will be that it is supported to translate the state and experiences to the Fedder it difficult to translate the states, experiences to the Fedder it is supported by I shall review the revenue implications of a Federal amnesty program and explain why we believe substantial revenue increases would be unlikely.

I. STATE AMNESTY EXPERIENCE

Beginning in December 1981, with Illinois, 29 states and the District of Columbia have conducted some form of an income tax amnesty program. Connecticut and Maine have scheduled tax amnesty programs for September 1 and November 1, 1990, respectively. Three states, Florida, Illinois and Louisiana, have offered two tax amnesty programs.

No agreement currently exists on the degree of success or failure of state amnesties, largely because data relating to the long-term effects are not available. Moreover, the specifications and conditions of ammesty programs have varied considerably from state to state. In general, state ammesty programs have offered reduced penalties to those individuals or corporations of ammentary components of the state tax autoniforment and correct their situation with the state tax autoniforment and correct their affunding which as reduced penalty rate; other programs have waived all penalties and interest. None have forgiven the actual tax lability.

State amnesty programs also have differed as to eligible participants. All state programs have included nonfilers. State programs, however, have varied concerning the eligibility of taxpayers who filed returns but underreported their taxes. Some state programs have allowed participation by people who are under investigation, or even with identified tax arrears.

A number of states have included accounts receivable under their ammesty programs. These accounts receivable represent tax liabilities that state tax authorities had already identified and

in some cases would have collected independently of the amnesty. States that have included accounts receivable have obtained significantly greater gross tax receipts through the amnesty than states not including accounts receivable. A 1987 Internal Revenue Service study showed that fully two-thirds of state amnesty revenue came from accounts receivable.

Many states' amnesty programs were instituted when enforcement of their tax laws was lax. Several states historically have had little or no auditing and many have long depended entirety on information provided by the IRS. For example, Kensse, Pennsylvania and Michigan do virtually no auditing. Virginia, Ohlo, West Virginia, North Dakota, Nebraska, Colorado, Louisiana, Oklahoma and Hawaii have tended to rely solely on information provided by the IRS in conducting state income tax audits. As IRS audit rates fell over the last decade, many state enforcement programs have concurrently suffered.

The vast majority of state amnesty programs have been coupled with increased enforcement efforts and increased civil or criminal penalties for tax evasion. Twenty-four of the states conducting income tax amnesty programs instituted these programs just prior to, or in conjunction with strengthening enforcement or penalties. Virtually every state vowed to pursue more vigorously tax delinquents and to impose harsher penalties.

In many cases, the states' enforcement and penelty increases were quite extensive. For example, Massachusetts enacted legislation that raised the crime of tax evasion to a felony, pecanited the contracting out of tax collection, authorized the hiring of more revenue agents, and made tax compliance a prerequisite for obtaining or renewing a state license, for example, for doctors and other professionals. To take but one other example, busisians doubled the number of its auditors and collectors.

In general, the increased enforcement efforts included:
(1) increased financial penalties for tax evasion and delinquency; (2) shifts in certain tax evasion crimes from misdemeanors to felonies and increased jail terms for certain crimes;
(3) expanded authority for property seizures; (4) improved
automated systems; and (5) increased staff for audits and
collections.

Advertisements emphasized the increased enforcement aspects of the states' amnesties, in particular, the significantly increased risk of tax delinquents being apprehended and subjected to stiffer penalties. The publicity campaigns were often dramatic:

- . California: "Get to us before we get to you."
- . Louisiana: "Pay now or pay later."
- . Minnesota: "Amnesty -- an offer you shouldn't refuse."
- . Colorado: "Don't say we didn't warn you."
- . Maryland: "Are you sure you can beat Maryland out of back taxes? Come forward and come clean."
- . New Mexico: "We have got your number, have you got ours?"
 Most recently, Virginia's amnesty program featured advertisements
 of a shark and "Jaws" music warning of impending increased
 enforcement of state tax laws.

Indeed, some states increased their enforcement efforts just before starting the amnesty program. For example, Massachusetts conducted a highly wisible comparion of business and property seizures prior to its amnesty program. In California, enforcement actions also were stepped up shortly before the amnesty period and were widely publicized. Similarly, in Louisiana, tax enforcement was increased before the amnesty program through the use of strike forces. The enforcement component is widely agreed that we be encentral to successful state amnesties, and, in fact these been central to successful state amnesties, and, in fact revenue.

In short, few states simply have used amnesties primarily as a quick revenue source. Rather, state amnesty programs have routinely been offered as the last chance for tax evaders to come can hight of greatly increased levels of enforcement. State statutor, forgrams have been fashioned as one element in a statutor, excluding the control of tax enforcement, coupled with enhanced administrative capacities.

The gross revenue collected under state smnesty programs has ranged from lows of \$150,000 and \$240,000 for North Dakota and Louisians, respectively, to high of \$182 million and \$401 million and

Very little information, however, is available on the net net and in revenue attributable to the state amenty programs. State inch as Massachusetts, that substantially increased tax penaltic state of the state amend of the state and the state of the stat

First, state and Federal tax systems are rather different and measures that might increase compliance in one system may have little or no impact in another. Thus, for example, a significant amount of state noncompliance involves sales taxes, which do not constitute an important part of Federal tax collections. Also, a large component of some states' amnesty receipts result from out-of-state residents failing to report their state income. No similar opportunities exist for a Federal amnesty program to obtain such revenues.

Second, states have lower income tax rates than the Federal system. Thus, it generally is less costly for delinquent taxpayers to participate in a state ammesty program than would be the case with a Federal program. These higher costs may deter participation in a Federal program.

Third, most state amnesty participants had not filed state returns. Data from some state annesty programs, however, indicate that most amnesty participants had already filed Federal income tax returns. This suggests that Federal enforcement efforts may have already identified and assessed most of the likely participants in an amnesty program. This leaves a pool of the program of the program of the late of the late

Fourth, most state tax ammesties forgave criminal as well as civil penalties. At the Federal level, more than one-half the criminal cases currently being pursued involve nontax crimes, such as drug offenses and money laundering. Great caution must be exercised so that a Federal tax amnesty does not become an occasion for excusing people engaged in other criminal activities.

Finally, and most importantly, the state amnesty programs that achieved the greatest success were those coupled with increased enforcement programs. Many states that tried amnesty programs did so when enforcement had been virtually nonexistent. In contrast with these states, the Federal government has long pursued vigorous enforcement policies and, indeed, already has many measures that were instituted by the warious states as part of their amnesty packages of their amnesty packages of their amnesty packages of their amnesty provisions to those applicable under the Federal tax law. Even if the IRS received significant increases in its enforcement budget, the percentage increases in enforcement effort could not match those of states that started from much lower enforcement levels.

Moreover, the kinds of penalty reforms undertaken by many of the states are not feasible at the Federal level. Federal tax penalties were dramatically increased during the 1980s and a comprehensive penalty reform measure was included as part of

last year's tax Act. Three out of every four persons convicted of Federal tax crimes are now receiving prison sentences, and the recently promulgated Federal sentencing guidelines will tend to increase the prison time served. There is little room at the Federal level for the kinds of enforcement reforms adopted by the states. A successful amnesty needs sticks as well as carrots.

In short, the Treasury Department questions whether a Federal sancesty program would provide comparable incentives for many of those currently noncomplying taxpayers to come forward. The states' experience simply does not translate to a Federal tax ammesty program.

The Treasury Department is also concerned that enacting a Federal amnesty program could raise serious public concern about the fairness of the current tax system. The serious public concern about taxpayers comply dutifully with the Federal tax seam of routinely pay their fair share of tax. They may fear the concerned others, who knowingly broke the rules, are allowed to escape punishment, or even to profit from their wrongdoing if the amnesty forgives interest on overdue taxes. Their natural reactions might be increased cynicism about the tax laws, which would undermine future compliance. Such a potential response would pose serious risks to a tax system that depends on taxpayers honestly reporting their own tax liability.

If a Federal amnesty program produces adverse responses from currently compliant taxps. Fers. it could have a substantial negative effect on long-term cax revenues. Even a program described as a "one-time" opportunity may lead taxpsyers to believe the program gist be repeated. These states, for example, have already had two amnesties in this decade. The system's ability to raise revenue would suffer from any program that jeopardizes voluntary taxpsyer compliance. A Federal tax amnesty program that therefore is a gamble with our tax system's most important asset — the general willingness of taxpsyers to obey the law.

Unfortunately, we do not have data necessary to evaluate with confidence the net impact of an amnesty program on long-run compliance. State tax administrators have not collected the data necessary to measure the effects of amnesty programs on compliance levels, and in those many cases where enforcement initiatives and manesty were married, such an analysis might not be possible.

Gross receipts from state amnesties significantly overstate the beneficial impact on revenues of an amnesty program because these receipts ignore the costs of an amnesty program. Net amnesty revenue is necessarily less than gross revenue shown on amnesty tax returns since some, and perhaps east, of the amnesty manual to the companion of the com

Net amnesty revenue consists of gross amnesty tax revenues less:

- Taxes that have already been collected, mainly through withholding.
- -- Accounts receivable and other known liabilities that would have been collected without an amnesty, payment of which is only accelerated. Accelerating the receipt of these amounts may not increase net revenue if the cost of acceleration is forgiveness of some or all outstanding penalties.
- -- Penalties that are forgiven during the amnesty on taxes that could have been collected during the same period without an amnesty and on taxes that yould have been collected later without an amnesty. At the Federal level, forgiven penalties could amount to billions of dollars.
- Actual costs of administering and publicising the amnesty program.
- The costs of transferring examiners and other tax administration personnel away from other work, offset by reduced audit and collection costs because some delinquent taxpayers use the amosety program. The revenue foregone from transferring examiners to assess the work and by the significant. The IRS would have to assess the participants would be allowed to except their past liability by admitting and paying only a smell portion of their unpaid taxes. Not checking ammenty fetures could also adversely affect future could lance.

One should also attempt to disaggregate gross revenues from state amnesty programs to identify revenues attributable to improved state enforcement activities. States that stiffened penalties and enforcement in conjunction with their amnesty programs no doubt would have experienced significant revenue increases solely from the change in compliance policy. The federal government would also experience revenue increases from helphtened enforcement effort, with or without an amnesty. It would be a mistake to credit an amnesty program with such

No specific proposal is under consideration here today. Therefore, we are not providing any revenue estimate for a Federal annexty program. However, the Treasury Department believes that there has been great overstatement of the potential believes that there has been great overstatement of the potential revenues that would occur from a general Federal tax annexty forgiving penalties and criminal prosecution. We regard, for example, fligures used by the Senate budget Committee predicting many billions of dollars of increased Federal revenues to be very exaggrented.

One design feature that would affect the revenue estimate is the amount of time between the date a federal mannersy program is announced to the general public and the date the amnesty program is effect. A long lead time might reduce net revenues. Once an annesty were scheduled, taxpayers would have an incentive to the samesty have a season of ling seturns since they might be able to do so without makes and filling seturns since they might be able to do so without makes and filling seturns since they might be able to do so without makes and filling seturns since they might be able to do so without makes and filling seturns of example of the manner of example of the same of the seturn of the same of the same of the seturn of the same of the same of the same of the seturn of the same of the same of the same seturn of the same of th

IV. CONCLUSION

In the currant budgetary context, we should emphasize our conclusion that a Federal amnesty program has limited short-term revenue potential. Futting additional enforcement resources and weapons into place cannot occur immediately, but only over a longer term. Amnesty absent enhanced enforcement is simply not wise tax policy. And, in any event, the administrative demands wise tax policy. And, in any event, the administrative demands between example of the amnesty program would require a substantial delay between examents. The program would require a substantial delay not be the context of the contex

Our lack of support for a general Federal tax amnesty program should not be mistaken for a lack of concern with current lavels should not be mistaken for a lack of concern with current lavels of taxpayer oncompliance. Not do we mean to praclude compaction of targeted tax enforcement programs, coupled with targeted tax relief. The principal lesson of the states programs is that an amnesty must be part of a package that includes enhanced an amnesty must be part of a package at nonfilers. Thus, for example, were penalty relief aimed only at nonfilers of the state of the program of the package including new 18% enforcementeed only as part of a package including new 18% enforcementeed the particles or an extended statute of limitations on tax assessments or collections.

Finally the risks of long-term, adverse effects of an amnesty on voluntary compliance suggest that even targeted relief should be undertaken with considerable caution.

This concludes my prepared remarks. I would be happy to answer any questions.

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Editorials

Tax amnesty and the federal budget

awmakers are so serious about balancing the federal budget that they want to cut some of our country's most popular entitlement programs, from Medicaid, Medicare and welfare to possibly even Social Security.

But before that happens, Gene Gavin thinks Congress ought to consider the most obvious source of potential revenue for the United States: The Internal Revenue Service. Mr. Gavin doesn't want federal taxes to increase. But he is in favor of having the IRS go after those people who either have underpaid their federal taxes, or haven't paid them at all.

Mr. Gavin, an accountant and Westport resident, also is Connecticut's revenue services commissioner. He thinks the U.S. government could raise billions of dollars to ease the budget shortfall by sponsoring its first-ever nationwide federal tax amnesty program. For proof, he figuratively is submitting receipts from about \$1100 million collected for Connecticut's Treasury during state tax amnesty programs held here in 1990 and 1995. And while he admits this would be a major undertaking for the IRS, he nonetheless maintains that we owe it to our citizens — particularly those who would be affected by drastic reforms in entitlement programs — to at least explore the possibility.

On that point, Mr. Gavin is right. If

On that point, Mr. Gavin is right. If Uncle Sam truly is leaving no stone unturned in his quest for additional revenues, then he should at least consider tax amnesty.

Such programs give those who underpay taxes, or don't pay them at The Issue:

Raising badly needed dollars, with help from the Internal Revenue Service.

all, an opportunity to settle their accounts over a set period of time. Under most amnesty programs, taxes owed are paid, along with the prescribed interest. The benefit to offenders is that they avoid stiff financial penalties and concern that they will be hauled into court — and possibly to jail — for breaking federal tax laws.

Connecticut does not have a corner on tax amnesty. Thirty-five other states have held such programs, most of them with great success, according to Mr. Gavin. But Connecticut is one of the few states to sponsor amnesty twice, and Mr. Gavin has become one of its most vocal proponents.

Tax amnesty is not without controversy. It irks law-abiding taxpayers, some of whom view amnesty as a perverse reward for tax cheats. Why should anyone follow the rules and pay their taxes every year, these people say, when you can pay them when you feel like it without fear of prosecution? Then there is the matter of secreey and confidentiality. One of the reasons state amnesty programs — including Connecticut's — have been so successful is that the states agree not to disclose identities of the participants to the IRS. That way, those owing state taxes can repay them, without worrying that the state will turn around and snitch to the federal government.

Whether the IRS, or even individual states, would agree to such a lack of reciprocity is undetermined. Also unknown: Whether scofflaws would trust such a guarantee, even if it were offered.

There would be practical difficulties too. The IRS already is operating on a restricted budget. You may recall that budget deficits prompted the agency to close its Norwalk taxpayer assistance office earlier this year, so that it will not be open for tax season. If such restrictions continue (and we have no reason to believe that they won't), then the IRS will have even fewer people to deal with the additional workload generated by tax amnesty cases. Mr. Gavin counters that Connecticut did not hire additional people to conduct last year's amnesty program. which he predicted will generate more than \$44 million once all the paperwork is processed. The 1990 program brought in \$55 million.

Then there is the stick problem. Tax amnesty programs work because offenders worry about what will happen to them if they don't participate. Connecticul promised to be far more vigilant about pursuing offenders once its amnesty programs ended, for instance. To be effective, the IRS would have to make a similar pledge. The question is: Can it follow through? If not, then Uncle Sam will have tax cheats from Maine to Hawaii laughing behind his back.

Tough issues, to be sure. But Mr. Gavin argues that we must explore them if, as a nation, we are dedicated to making government as efficient as possible. The idea is worth considering.

Chairman JOHNSON. Thank you very much, Mr. Gavin. Mr. Hoatlin.

STATEMENT OF THOMAS M. HOATLIN, COMMISSIONER OF REVENUE, STATE OF MICHIGAN, DEPARTMENT OF TREASURY

Mr. HOATLIN. Good morning, Madam Chairman, and Members of the Subcommittee.

My name is Thomas Hoatlin. I am the revenue commissioner for the State of Michigan.

I am here to testify on Michigan's experience in using a private collection agency to support our collection efforts, and also to sup-

port H.R. 757.

The Michigan Department of Treasury had an amnesty program in 1986, which was immediately followed by the implementation of a number of improved enforcement tools to collect our delinquent taxes.

As a part of that process, the department contracted with a private collection agency to build and manage an automated collection site, the Michigan Automated Collection System.

The purpose was to collect delinquent taxes the department did

not and could not collect with existing personnel.

The collection process in Michigan represents 16 tax types and 21 active debt types that we collect on behalf of other State agencies, and local court systems.

Accounts are assigned only after they are collectible, that is, all appeal provisions have run, and the liabilities are coded for current action.

Accounts are assigned to three different collection units. One, the Treasury central office; two, the Treasury field collectors; and then the automated collection system.

Michigan has contracted with a private collection agency for 10 consecutive years. The current vendor is responsible for five primary areas; that is, the management of the collection site, facilities management, programming staff to maintain and enhance the computer programs, the management of a bankruptcy unit, and the maintenance of a LAN system.

The site is open 12 hours a day, 5 days a week, and 4 hours on

Saturday.

Over the 10-year period, starting in 1986, the annual collections have grown from \$29 million in 1986 to \$106 million in 1995.

Our experience with privatization of the collection process has been very good. The program, from its inception, was developed to collect delinquent taxes for which we lacked sufficient technology and personnel to collect in a systematic way.

Based on our experience, the automated telephone collection method is extremely cost effective and efficient. Whether it is performed by the public sector or private sector, telephone collections are extremely cost effective.

And the sooner the debt is collected, the better the collection. The

older debts are much more difficult to collect.

There were no State employees that were displaced by the result of contracting with the collection agency. All contract employees are subject to the same confidentiality provisions as State employees. The collection agency uses a telephone script that is approved by the State, and all levy and lien activity done by the private contractor is approved by State employees through an interface system.

Michigan also has an offset program that intercepts all vendor payments and all tax refunds through a main accounting system

that is run against our accounts receivable.

The program in 1995 generated offsets of \$28 million. If the private contractor has been assigned an account on which an offset is

taken, no commission is paid on that offset.

The offset programs have worked very well and I am only here to support H.R. 757. Michigan, at this point, does not participate, is not one of the 31 States that participate in the program, and we are more than willing to start as soon as the reciprocal agreement is approved.

Thank you.

[The prepared statement follows:]

STATEMENT OF THOMAS M. HOATLIN COMMISSIONER OF REVENUE STATE OF MICHIGAN

My name is Thomas Hoatlin. I am the Revenue Commissioner for the State of Michigan. I have been employed by the Michigan Department of Treasury for 36 years, spending all of my tenure in the area of tax administration and the collection of various state taxes.

I am here to testify on Michigan's experience in using a private collection company to support our collection effort. I am also here to offer support of H.R. 757.

The Michigan Department of Treasury had an amnesty program in 1986 which was immediately followed by the implementation of a number of improved enforcement tools for the collection of delinquent taxes. As a part of the collection process, the Department contracted with a private contractor to build and manage an automated collection site, the Michigan Automated Collection System (MACS), for the purpose of collecting taxes which the Department could not collect with existing personnel.

The collection process in Michigan involves 16 tax types and 21 active debt types collected on behalf of other state agencies. Accounts are assigned only after they are considered collectible, that is, after all appeal periods have run and the liability is coded for current collection responsibility. Accounts are assigned to one of 3 collection units:

- 1. Treasury Collection Division's central office;
- 2. Treasury field collectors; or
- 3. Michigan Automated Collection System.

Michigan has contracted with a private collection firm for over 10 consecutive years. The current vendor provides services in 5 primary areas:

- Management of the automated collection telephone operations site, including approximately 280 contractor employees serving as account representatives and management staff.
- Facilities management (operations, technical support, and maintenance) of the computer and the related network and peripheral equipment which supports the MACS application system and its interfaces to assure continuous system and data reliability and to assure the smooth transfer of data between Treasury and the MACS database.
- Programming staff to maintain and enhance computer programs supporting collection activities
 and interfaces between the MACS database and the lien release system and the State Treasury
 Accounts Receivable (STAR) database on Treasury's mainframe computer.
- Management of a 10-person bankruptcy unit whose efforts to track bankruptcy claims and discharges rely on a PC-based local area network (LAN).
- Maintenance of a 3-person LAN management team to facilitate the operations of the bankruptcy LAN at the primary collection site and 66 PCs located at a second telephone collection site.

The site is operated 12 hours a day, Monday through Friday, and 4 hours on Saturday. The 1995 fiscal year collections on accounts assigned to the automated collection system totaled \$106 million. Over a 10-year period, starting in 1986, the annual collections have grown from \$29 million to \$106 million in 1995. An additional \$170 million was collected in fiscal year 1995 through the efforts of our central office and field operations.

Our experience with privatization of the collection process has been very good. The program, from its inception, was developed to collect delinquent taxes for which we lacked sufficient technology and personnel to collect in a systematic way. Based on our experience, the use of automated telephone collection methods is extremely efficient and cost effective, whether the work is performed by the public or private sector. The key to success in either case is the speed with which an account can be resolved; the older the debt, the more difficult it is to collect. No state employees were displaced as a result of contracting with the private collection agency.

All contract employees sign the same confidentiality documents that state employees sign. The collection agency uses a telephone script which is approved by the state and follows all of the courteous telephone etiquette responses that would be used by a state employee when contacting a taxpayer indebted to the state. We also reserve the right to monitor calls to verify the quality of the staff training and the interaction with the taxpayer. We do, from time to time, receive complaints—however, no more than we would receive when state employees are making such calls.

The State of Michigan is in the process of issuing a Request for Proposal (RFP) for a new automated collection system and improved telephone collection software. A component to be required in the new system software will provide a means to target the most effective collection methodology for a specific taxpayer based upon the compliance history and other factors related to that taxpayer. In terms of hardware, we intend to convert from a legacy mainframe system to a client/server environment. We also intend to modify the existing structure of the Collection Division to allow a longer period of time for internal collection efforts on tax debts prior to unresolved accounts being assigned to private collection agencies for enhanced collection efforts.

As many of our delinquent taxpayers represent new accounts receivable, rather than habitually delinquent debtors, we prefer to have a state employee make the initial contact with the debtor, in an effort to achieve early account resolution or, if necessary, account correction. Those taxpayers who are habitually delinquent may require a different collection effort.

Michigan intends to implement an integrated tax system which will enable us to discuss all existing delinquencies as well as those liabilities nearing a final assessment or for which recent returns have not been filed timely. For example, a taxpayer may have an income tax withholding assessment. S/he may also be delinquent for other taxes administered by the Department or debts owed to other state agencies for which Treasury has been assigned collection responsibility. With the integrated tax system, all liabilities will be readily visible on the computer monitor, including corporate officer liabilities, and serve to guide the discussion with the taxpayer regarding the totality of his/her debt with the goal of resolving the entire set of liabilities. Ultimately, our goal will be to encourage and foster more voluntary compliance with all tax laws, thereby reducing the growth in accounts receivable.

Michigan has an offset program that intercepts vendor payments and tax refunds to be issued by the state and applies the intercepted funds against all debts recorded on the state's accounts receivable database. In fiscal year 1995, this program generated an offset of \$28 million. If the private contractor has an assigned account on which an offset is taken, the firm does not receive a commission on that payment.

As I indicated, I am also here to support H.R. 757. There are several points I would ask you to keep in mind regarding the legislation:

- This legislation allows the states to participate in an existing federal offset program and allows
 the IRS to reciprocate for what many of the states are already doing. The IRS would be allowed
 to offset federal income tax refunds to satisfy legally enforceable, past-due state tax debts.
- These tax delinquencies will have already exhausted the period of time allowed for protests and appeals. The bill also affords some protection to the taxpayers as they will be given specific notification before any offset occurs. IRS would be paid for its expenses, even though states seldom require the federal government to pay for its participation in their programs.
- The states currently are offsetting over \$80 million annually on behalf of the federal government.
- This measure has been publicly aired before two hearings and has never received any public or government objections. The U.S. Treasury Department and IRS support the proposal.

I urge you to take all necessary steps to assure that this legislation is included in the next available bill.

This concludes my testimony. I want to thank you for the opportunity to describe two issues that are very important to the states.

Chairman JOHNSON. Thank you, Mr. Hoatlin. Mr. Goldberg.

STATEMENT OF GERALD H. GOLDBERG, EXECUTIVE OFFICER, CALIFORNIA FRANCHISE TAX BOARD

Mr. GOLDBERG. Thank you, Madam Chairman, Mr. Matsui.

My name is Jerry Goldberg and I am the executive officer of California's Franchise Tax Board, the State agency that is responsible for the collection of both personal and corporate income tax.

I would like to thank you for inviting me here to testify. My remarks will cover three areas. The Franchise Tax Board's experience with outsourcing tax debt collection, the Franchise Tax Board's experience with insourcing for county and other State tax collection, and California's support for the reciprocal fund offset legislation to authorize the Federal Government to offset Federal tax refunds to settle past due State tax debts, thus reciprocating the States in a program where California and 30 other States already offset State tax refunds to settle Federal tax debts.

With regard to outsourcing, California has had a program for referring certain types of tax debt to private collection agencies since

1984.

The primary purpose of the program was to increase the efficiency and fairness of our collection program in recovering debts owed on small accounts which otherwise would not be pursued.

The programs involved are known as the OSCAR Program for out-of-state collections of accounts referral, and the ISCA Program for in-state collection of accounts referral.

Accounts selected are selected based on their cost-benefit ratio, that is to say, in California, the benefits have to be less than \$5 of revenue to \$1 of cost.

Vendors are selected based on competitive bid. We monitor very closely the contractors. We actually colocate with them. We use our internal auditors to audit them, and in fact we provide training to the vendors.

We do clearly recognize that tax debt is significantly different than commercial debt. Because the accounts referred are small amounts, the Franchise Tax Board has never expected a great direct monetary return for the program, but, rather, as I said, it is an issue of effectiveness and fairness.

We also have an insourcing program and the Franchise Tax Board has one of the most sophisticated automated collection systems in the country, and as a consequence we use our collection system to not only collect tax debt but delinquent child support, delinquent vehicle license fees, delinquent county court-ordered debt, and of course various other items of debt as well.

Finally, I would like to speak to the issue of the reciprocal offset. California has had an offset program since 1975. The IRS became a participant in the program in 1991, when it received roughly \$16.3 million from California from roughly 73,000 accounts.

In 1995 the IRS made 741,000 offset requests. In effect 25 percent of all of the offset requests made in California were requested by the Internal Revenue Service on behalf of the Federal Government.

Since 1991, California has remitted \$91.8 million to the Federal Government.

Clearly, California has an interest not just in reciprocity with the Federal Government, but also on its own behalf in terms of the moneys that we would collect, which otherwise would not be col-

lected if there was not a Federal offset program.

We anticipate that California would receive in the first year of operation roughly \$80 to \$85 million, and in succeeding years it would be significantly less. Obviously, we would be collecting during the first year on a backlog. In future years the amount would be significantly less, but nonetheless, a significant amount of money.

We are obviously very supportive of Representative Jacobs' bill, H.R. 757, and are very hopeful this Subcommittee makes a positive

recommendation with regard to it.

We do feel it would be very much a step forward in ensuring a cooperative attitude between the States and the Federal Government, and of course, more specifically, between the State tax collection agency and the Internal Revenue Service.

Again, I want to thank you for this opportunity to testify.

[The prepared statement follows:]

STATE OF CALIFORNIA





TESTIMONY OF GERALD H. GOLDBERG CALIFORNIA FRANCHISE TAX BOARD BEFORE THE OVERSIGHT SUBCOMMITTEE OF THE HOUSE WAYS AND MEANS COMMITTEE HEARING ON TAX DEBT COLLECTION ISSUES April 25, 1996

EXECUTIVE SUMMARY

I am the Executive Officer of the California Franchise Tax Board (FTB) which administers the personal income tax and the bank and corporation tax for the State of California. This statement will serve to explain the FTB's experience with the outsourcing of certain kinds of tax debt, FTB's experience with the "insourcing" of other types of government debt which have been referred to FTB for collection, and discuss the question of reciprocal refund offsets and support for Federal legislation that would allow the Federal government to offset Federal tax refunds to settle past due tax debts as most States voluntarily do now for the Federal overnment.

Outsourcing State Tax Debt

California has had a program for referring certain types of tax debt to private collection agencies since 1984. The primary purpose of the program was to increase the efficiency of our collection program in recovering the debts owed on small accounts which would otherwise not be pursued. The programs involved are known as OSCAR (out of state collection of accounts referral) and ISCAR (in-state collection of accounts referral).

Because of the nature of the accounts referred to the private collection agencies, FTB never expected a great direct monetary return for the program. Revenue attributable to the collection agencies for an average twelve month period is approximately \$4.5 million for OSCAR and \$1.2 million for ISCAR. The specific cost-benefit ratio for the ISCAR and OSCAR programs is much lower than the ratio of in-house collections. Even with the low return per dollar expended, we feel that the ISCAR and OSCAR programs are valuable because they increase awareness in the community of the consequences of ignoring tax debt. In the case of both programs, if the accounts were not referred to the OSCAR and ISCAR vendors, no follow-up would occur after the automated cycles are completed.

"Insourcing" Other State Debts

FTB has created one of the most sophisticated automated collection systems in the country. In recognition of our success, California has been experimenting with "insourcing." FTB has been given responsibility for collecting some debts owed to other State and local agencies. Legislation was enacted granting FTB the authority to collect these debts as though they were tax liabilities. FTB has collected \$348.5 million in non-tax debt during the last three years.

Reciprocal Refund Offset Legislation

California has an offset program through which debts owed to other State agencies and the Federal government may be offset against tax refunds and lottery winnings. In 1995, California remitted \$26.3 million to the Federal government as a result of offsets of State income tax refunds which were used to satisfy Federal tax debts. Over the last five years, we have remitted more than \$91 million to the Federal government. If H.R. 757 were passed, the Federal government could use its offset program to collect certain state tax debts.

Madame Chairman and Members of the Subcommittee, thank you for inviting me here today to share the California Franchise Tax Board's experience with the outsourcing of certain kinds of tax debt. I will also touch on the FTB's experience with the "insourcing" of other types of government debt which have been referred to FTB for collection. Finally, I will discuss the question of reciprocal refund offsets and support for Federal legislation that would allow the Federal government to offset Federal tax refunds to settle past due tax debts as most States voluntarily do now for the Federal government. As you know, California uses it offset program to collect various Federal debts. In 1995 California remitted \$26.3 million to the Federal government as a result of offsets of state income tax refunds which were used to satisfy Federal tax debts. Over the last five years, we have remitted more than \$91 million to the Federal government. If H.R. 757 were passed, the Federal government could use its offset program to collect certain state tax debts.

I am the Executive Officer of the Franchise Tax Board, the State Agency responsible for administering the Personal Income Tax and the Bank and Corporation Tax for the State of California. In fiscal year 1994/95, the two tax programs produced over \$24.1 billion in revenues, or approximately 56.7 percent of California's General Fund. Of the total, Personal Income Tax accounted for approximately \$18.5 billion (43.3%), and Bank and Corporation Tax accounted for \$5.7 billion (13.4 %). In 1994/95, 13.4 million personal income tax returns were filed, and nearly one-half million bank and corporation tax returns.

Outsourcing State Tax Debt

Background

- California has had a program for referring certain types of tax debt to private collection agencies since 1984.
 - The primary purpose of the program was to increase the efficiency of our collection program in recovering the debts owed on small accounts which would otherwise not be pursued
 - The programs involved are known as OSCAR (out of state collection of accounts referral) and ISCAR (in-state collection of accounts referral.)
- 2. The California Franchise Tax Board is a highly sophisticated and successful debt collector.
 - Each year we develop a collections workplan which prioritizes the debt so that our budgeted resources are devoted to the most cost effective collection models.
 - Our workplan puts highest priority on those accounts which can be collected through our automated collection system which issues notices during the voluntary collection cycle and can identify assets and issue levies during the involuntary cycle.
 - Only after an account has completed both the automated cycles is it referred to our collectors for manual resolution.
- 3. Manual collections are labor intensive and expensive.
 - · Each year FTB is budgeted to work down to a specific level on the workplan.
 - Historically, this level has been at approximately the 5 to 1 level. That means that we
 only assign accounts for manual collection if they are expected to return at least \$5
 for every dollar of State cost.
 - This system maximizes State returns but historically it meant that small debtors
 whose debts could not be collected during the automated process escaped all further
 collection action.
- In 1984 the Franchise Tax Board sought legislative authority to begin outsourcing debts which were below the 5 to 1 ratio.
 - Our intent was primarily to increase the effectiveness and visibility of collection action among the group of small tax debtors because of its deterrent value.
 - We also hoped to marginally increase the return to the State even though we did not regard many of these small accounts as fully collectible.

How the Program Works

- Accounts referred to private collectors must be in excess of \$100 and to have completed both the voluntary and involuntary automated cycles.
- Private collection agencies are selected through competitive bids and multiple year contracts
 are awarded. The agencies FTB contracts with have to meet stringent criteria having to do
 with financial viability, staff training, and the ability to meet our strict confidentiality
 requirements.
 - In order to assure that the private collection agencies are adhering to our requirements we:
 - · periodically send in our internal auditors to review their practices,
 - · provide training for their staff,
 - co-locate our staff and collection agency staff so that we can do onsite review and problem resolution.
- Private collection agencies are authorized to take standard manual collection actions generally they send letters and make telephone contact with the debtor.
- 8. Collection of tax debt is different from the collection of much commercial debt in that the debtor often has questions about the underlying legitimacy of the debt. This is true even thought the debtor has had previous notices and has not chosen to exercise his administrative protest and appeal before the debt "went final."
 - · Taxpayers frequently feel that they do not owe the debt.
 - In other cases they may question the legitimacy of penalty or interest calculations.
 - They may assert that the debt was paid but credited to the wrong year or the wrong account.
- The private collection agencies are not allowed to take further collection action if the debtor raises questions about the authenticity of the debt or asserts that he has not been given due process.
 - In these cases, the debt must be referred back to FTB and it is resolved by our
 collection staff who have access to the taxpayer's complete record.

Cost and Return to the State

- 10. Because of the nature of the accounts referred to the private collection agencies, FTB never expected a great direct monetary return for the program.
 - We refer approximately 24,000 accounts to OSCAR and another 24,000 accounts to ISCAR annually.
 - The accounts referred to OSCAR average \$4,400 while the accounts referred to ISCAR average \$1,500.
 - Of these, the program results in payment in full of approximately 10% of the referrals annually. In other cases partial payment is obtained or the debts are finally discharged as uncollectible.
 - Revenue attributable to the collection agencies for an average twelve month period is approximately \$4.5 million for OSCAR and \$1.2 million for ISCAR.
 - Vendors receive a fixed percentage of the dollars they collect. Under the current contracts, the OSCAR contract pays 15% of the dollars collected while the ISCAR vendor receives 20% of the dollars collected.
- 11. The specific cost-benefit ratio for the ISCAR and OSCAR programs is much lower than the ratio of in-house collections and the program required significant direct support from FTB collections staff.
 - FTB has 28 full time State staff assigned to the program.
 - They handle the respondes to our final letter which informs debtors that their debts will be referred to a collection agency if prompt payment is not received.
 - They also handle all cases where the taxpayer has questions about the nature
 of the underlying assessment.
- 12. Even with the low return per dollar expended, we feel that the ISCAR and OSCAR programs are valuable because they increase awareness in the community of the consequences of

- ignoring tax debt. In the case of both programs, if the accounts were not referred to the OSCAR and ISCAR vendors, no follow-up would occur after the automated cycles are completed.
- 13. In States which have less effective automated collection programs the difference between the return on the dollar for State efforts and private efforts may not be as great.

Problems Encountered with the Private Collection Agencies

- 14. FTB has encountered some problems with the ISCAR and OSCAR programs.
 - One in-State vendor declared bankruptcy while under contract to FTB and we had some difficulty assuring that all of our accounts were returned.
 - In the early days of the program we had some complaints about harassment and collection efforts which were too aggressive.
- 15. These problems have been resolved through better screening of vendors and the provision of increased training and oversight by FTB staff.

Relationship with the State Employee Unions

Section 19130 of the California Constitution permits "contracting out" under certain conditions one of which is that:

"The contract does not cause the displacement of civil service employees. The term 'displacement' includes layoff, demotion, involuntary transfer to a new class, involuntary transfer to a new location requiring a change of residence, and time base reductions."

This provision did not present a problem with regard to OSCAR since no State employees were collecting out of State debt. However, when legislation initiating ISCAR, the in-State collection program, was introduced in 1986, there was concern that State employees might be displaced. FTB staff met with the State employee unions and obtained their support for a pilot program. The unions were cooperative because FTB had never been funded to collect debts where the likely cost-benefit ratio was expected to be below \$5 to \$1. So long as the legislation required that the ISCAR referrals be made from the accounts below this level on the collection work plan, no State employees would be displaced.

"Insourcing" Other State Debts

Background

FTB has created one of the most sophisticated automated collection systems in the country. In recognition of our success, California has been experimenting with "insourcing." FTB has been given responsibility for collecting some debts owed to other State and local agencies. Legislation was enacted granting FTB the authority to collect these debts as though they were tax liabilities. FTB has collected \$348.5 million in non-tax debt during the last three years.

Child Support

Since 1994, FTB has been collecting delinquent child support referred to us by the district attorneys of 19 California counties. The program will eventually be available to all 58 counties.

- As of March 31, 1996, the program has collected \$87 million from 348,000 cases.
 - \$50 million was returned to counties as reimbursement for AFDC payment.
 - \$37 million went directly to families which are not on the AFDC rolls.
- Another \$34 million in child support delinquencies was collected through referrals to our offset program in which we offset county debts against income tax refunds and lottery winnings.
- We have been able to build an automated system to handle child support delinquencies which parallels our tax collection system.
 - By using the automated system as our primary collection vehicle, the return for each dollar of cost has been \$79 to \$1.

Vehicle License Fee Collections

- Since 1994, FTB has been responsible for collecting delinquent vehicle license fees for the Department of Motor Vehicles.
- When we received the program, it was primarily a manual process. For the first 18 months we ran a manual collection program while we developed an automated system.
- With the completion of the automated system, our monthly collections have doubled from \$3 million to \$6 million per month.
- Since the inception of the program, we have collected more than \$79 million from 475,000 accounts.

Court-Ordered Debt Collections

For nine months, FTB has been working with nine counties to develop and implement a program to collect court-imposed fines, penalties and restitution orders. By the end of fiscal 1995/96, we will have collected more than \$2 million from 32,000 cases. As we come to understand the nature of these debts, we hope to be able to develop an effective automated system in this area as well.

Due Process Concerns

In the case of accounts which FTB refers to OSCAR and ISCAR, the private collection agency must return all accounts to us for resolution if the taxpayer questions the legitimacy of the debt. In the case of debts which are "insourced" to FTB from other agencies, a similar rule applies. If the debtor questions the legitimacy of the debt, the amount of the debt, or asserts that he has not had due process, FTB returns the debt to the referring agency for resolution.

Reciprocal Refund Offset Legislation, H. R. 757

Current Federal Benefits Received from the California Offset Program

As you know, California has an offset program through which debts owed to other State agencies and the Federal government may be offset against tax refunds and lottery winnings.

- The California program began in 1975. That year we intercepted tax refunds for 15 State agencies. We collected \$446,000 on 7,500 delinquent accounts.
- 2. The program has grown considerably. The IRS became an active participant in the California offset program in 1991 when it received \$16.3 million from 73,136 accounts.
- 3. In the 1995 process year we received 2.98 million request for offsets from county, State, and Federal agencies.
- 4. Of these, refunds were offset for 384,404 accounts for a total of \$76.9 million.
- 5. Federal offset requests made up 743,121 of the 1995 offset requests.
 - We were able to offset refunds for 92,691 Federal accounts and remitted \$26.3 million to the Federal government in 1995.
- 6. Since 1991, California has remitted \$91.8 million to the Federal government.

Potential Benefit to California from a Reciprocal Federal Offset Program

- FTB has estimated the impact of expanding the Federal offset program to include the collection of State tax debts.
 - After matching a tape of State tax debts to a tape of IRS refunds we identified approximately 200,000 accounts which were on both tapes.
 - The value of the offsets which could have been made was \$85 million.
- 2. It is probable that California would recognize something in the order of \$85 million in the

- first year of an expanded offset program.
- It is unclear what the annual value of expanded Federal offsets would be once the outstanding debts had been recovered, however, it is likely to be a substantial amount on a ongoing basis.
- 4. The Federation of Tax Administrators (FTA) estimates that a Federal offset program could increase receipts to income tax States by about \$150 million to \$200 million annually in the early years and by somewhat lesser amounts as the inventory of receivables is reduced.

Safeguards Which Should be Included in a Federal Offset Program

Based on the Franchise Tax Board's experience with our offset program, I support the following concepts that are included in H.R. 757.

- No account will be referred for offset until all the administrative protest and appeal processes have been exhausted and the taxpayer has received due process.
- California has established a hierarchy of debts by statute which provide direction in case the
 offset amount is not sufficient to satisfy all outstanding State, local, and Federal debts. I
 support the provision in the Federal legislation that identifies such priorities as well.

Finally, I know that concern had been expressed that States might use a Federal offset provision to collect unpaid "source tax" debts from non-residents's pension income. In fact, Committee Chairman Archer raised that issue in a letter last year to California Governor Pete Wilson. The enactment of P.L. 104-95, pension source tax restrictions, has eliminated that possibility.

Conclusion

In conclusion, I want to thank you for inviting my testimony. I would gladly offer my assistance to the Subcommittee as these proposals advance. I would hope that the Subcommittee would soon act favorably on the reciprocal refund offset measure sponsored by Rep. Andy Jacobs. This measure enjoys bipartisan support and to my knowledge has not received any strong objections from members of this Committee. Passage of H.R. 757 will be of great help to the States as they strive to balance their budgets without raising taxes. It is always better to collect all of the taxes that are legally due and owing rather than imposing an additional burden on honest taxpayers. Passage of H.R. 757 will help the States to accomplish this goal. This measure is also a revenue raiser for the Federal government. The Joint Committee on Taxation has scored the measure as bringing in \$8 million dollars to the Federal government over five years in addition to the over \$80 million the Federal government now receives annually from those States who voluntarily assist the Federal government through their offset programs.

Chairman JOHNSON. Thank you, and also for your interesting numbers.

Mr. Duncan.

STATEMENT OF HARLEY T. DUNCAN, EXECUTIVE DIRECTOR, FEDERATION OF TAX ADMINISTRATORS

Mr. Duncan. Thank you very much, Madam Chairman, Members of the Subcommittee. It is a pleasure to be here on behalf of the Federation of Tax Administrators, which is an association of the principal tax administration agencies in each of the 50 States, the District of Columbia, and New York City.

My purpose today is to first, share the results of a survey concerning the use by State tax administration authorities of non-government contractors for collecting State tax debts, and second, to urge the Subcommittee to approve H.R. 757, establishing a refund offset program for past due legally owing State tax debts.

The survey we conducted was done in April of this year to gather information for the purposes of the Subcommittee, on the State use

of private collection agents.

Our results can be summarized, broadly, as follows. First of all, 39 of the 51 jurisdictions surveyed used outside agencies for the collection of tax delinquencies, and some have done so for as long as 10 to 15 years.

At the outset, most of these programs were primarily for the collection of individual income tax liabilities of persons who were no

longer residing in the State.

Over time, there has been an evolution, however, to a greater use of outside collectors for in-State taxpayers. We now have 25 States that use it for in-State taxpayers as well as out of State, and for a broader array of taxes, both individual and business taxes.

The types of activities for which they use private collectors include skip tracing, collection letters, telephone calls, payment proc-

essing, and negotiating and approving payment plans.

Smaller numbers use them for asset seizure, liens, and levies,

garnishments and negotiating compromises of the debt.

It is important to recognize that in no State is the collector given carte blanche authority, but as these gentlemen have indicated, each of them operates under a contract that is very specific with respect to the procedures that will be used, the timing of the calls, the training that is required, and the like.

Most State programs are small in relationship to the overall col-

lection effort. Again, it focuses on individual income taxes.

But again, there is a growing number of States that are making the private collection agency an integral part of their overall collection effort, much like the State of Michigan. I would refer you to New Jersey, Delaware, and Pennsylvania in that regard.

States see these as fine complements to their own collection programs. With respect to compensation, they are largely compensated on a contingency basis, except where they are an integral part,

where they may be on an hourly basis.

In terms of disclosure, generally, the collector is provided only with a name, address, Social Security number, tax type that is owed, and the amount that is owed. They do not have access to detailed account information.

We have provided complete results of this survey to the Sub-committee.

Let me turn, now, to H.R. 757 which would establish a program for the IRS and the Treasury Department to offset a Federal tax refund to satisfy past due, legally owing State tax debt.

State tax administrators see this as a simple, straightforward

matter of reciprocity in tax administration.

As you have heard, 32 States currently provide this service for the Federal Government. H.R. 757 would allow them to reciprocate and include State tax debts as a part of the current Federal offset program.

There would be no State tax debt satisfied until all current debts

are satisfied from the offset.

I want to speak a moment to the issue of using the offset program for nonresidents, and the concern that has been expressed.

We would urge the Subcommittee to move cautiously in this area and to avoid placing unreasonable restrictions on the types of State tax debts that could be satisfied under the offset program.

To deny the applicability of the refund offset program to all types of tax debts owed by all nonresidents is to suggest that income taxes imposed on any nonresident are, in some sense, illegitimate.

Nothing could be further from the truth.

The Supreme Court has upheld the right of a State to levy an income tax against a nonresident for 75 years, and all States do so. It would be as if to say a resident of New York could travel to Connecticut every day to earn his or her livelihood and would have no

liability to the State of Connecticut.

That is simply not the way our income taxes work.

The Subcommittee needs to remember that before a debt is referred to the offset program, it must be reduced to a judgment in the originating State, meaning it has to go through a process that meets the due process requirements of the constitution.

There is another required notice to the taxpayer before it can be referred to the IRS and that notice must go to the most current ad-

dress known to the IRS.

Finally, if the taxpayer protests that last letter, the debt cannot ultimately be referred for offset. So we have all of the processes at the State level to reduce it to a judgment and a subsequent notice before it could ever go to the IRS for offset.

Finally, once the offset is made, there is still one more chance to contest the liability and to have the refund released in the name

of the taxpayer.

As I have indicated, we think this is a matter of reciprocity in tax administration and look forward to working with your Subcommittee to produce an acceptable measure.

Thank you.

[The prepared statement and attachments follow:]

STATEMENT OF HARLEY T. DUNCAN EXECUTIVE DIRECTOR FEDERATION OF TAX ADMINISTRATORS

Madame Chairperson and Members of the Committee:

My name is Harley Duncan, and I am Executive Director of the Federation of Tax Administrators. My purpose before the Subcommittee today is twofold. First, I have been asked to share the results of a survey conducted by the Federation concerning the use by state tax administration authorities of non-government collection agents for collecting state tax debts. Second, I wish to urge the Subcommittee to approve the provisions of H.R. 757, establishing a refund offset program for past-due, legally owing state tax debts.

The Federation of Tax Administrators is an association of the principal tax administration agencies in each of the 50 states, the District of Columbia and New York City.

State Use of Private Collection Agents

Introduction

This survey of the 50 states and the District of Columbia was conducted in April of this year. Our goal was to learn as much as possible about the experiences states have had with non-government contractors, rather than to develop a statistical analysis. All 51 governments were queried; however, not every question fit each state's process. Thus, not every question was answered, and it would not be accurate to report in terms of what percentage of the states take one approach, and what percentage takes another. Instead, I will focus on the issues, successes and problems, and variations on approach that were revealed by the survey. A detailed compilation of the survey results has been provided to the Subcommittee.

Summary of Results

The broad results of the survey can be summarized as follows:

- A large number of state tax authorities (39) use outside agencies for the collection
 of tax delinquencies; some have done so rather extensively for ten or 15 years.
- At the outset, these programs tended to be primarily for the collection of delinquencies from individual income taxpayers who are no longer in the state. Today, in-state programs are increasingly popular, and outside collectors are assigned a broader array of state tax debts.
- The activities for which the largest number of states turn to private collectors include, skip tracing, collection letters, telephone calls, payment processing, and negotiating and approving payment plans. Smaller numbers use contractors for asset seizure, liens/levies, garnishment, and negotiating debt compromises.
- While a large majority of states use outside collectors, these are typically small
 programs in relation to the entire collection activity. Several states, however, are
 now using outside agencies as a primary or integral part of the collection
 program rather than only as a method of dealing with residual debts remaining
 after state collectors have worked the account.
- Overall, states have reported to us that they find these programs to be a useful component of an overall collections program and that they generally do not receive complaints about the use of outside collectors.
- States generally do not disclose detailed account data to outsider collectors, and disclosure restrictions seem to provide adequate protection of taxpayer privacy.

Detailed Results

Types of Taxes. There are 39 states which use private or non-government agents in the collection of delinquent taxes. The oldest of these programs dates to 1975; most were instituted in the mid-1980s. About one-third of the states use outside agencies for the collection of individual income taxes only, while two-thirds have programs for the collection of all taxes, including individual income taxes.

A slightly higher number of state use outside contractors for out-of-state accounts than for in-state accounts, but my personal perspective is that this gap is shrinking. Fifteen states use outside agents for collecting certain types of debt pertaining to all

tax types for both in-state and out-of-state accounts, and four others use it for both in-state and out-of-state individual and business income accounts and sales tax receivables.

Contracting Agents. Most states contract with private collection agencies, although four states also have contracts with independent or prosecuting attorneys. We identified two states that contract with county sheriffs.

Seven states reported that they require their contractor to devote a special team to their work, so that a collector will not be working retail delinquencies and tax delinquencies at the same time.

While almost all states contract on a contingency or percentage-of-collection basis, there are programs for flat fees — that's usually reserved for collecting bounced checks — and two states tell us they add a collection fee to the total tax, penalty and interest.

Activities Contracted. States contract out for a wide variety of collection activities, including skip tracing, sending collection letters, making phone calls, and even receiving and processing payments. The activities that are least frequently contracted for are face-to-face visits, lockbox services and asset location.

The most frequent coercive action taken by an outside agent is to make phone calls. A large number of states -- by actual count, 27 of the 39 -- said they allow these agents to negotiate and usually approve payment plans; a smaller number give their agents the authority to negotiate compromises. However, the states must usually give final approval to each compromise.

We identified eight states which allow asset seizure, seven states which give the authority for wage garnishment, and more than a dozen which will permit the outside agency to undertake litigation, although this seems to universally require prior approval of the state.

A synopsis of the types of activities for which states use outside agencies is presented below.

	Number of States	
Activity	In-State	Out-of-state
Skip Tracing	17	20
Collection Letters	20	23
Collection Calls	22	27
Face-to-Face Visits	4	6
Receiving Payments	17	20
Lockbox Services	1	1
Asset Location	7	9
Litigation	9	15
Telephone Dunning	25	32
Asset Seizure	4	7
Issuing Liens/levies	6	5
Wage Garnishment	7	9
Negotiating Pay Plans	23	27
Approving Pay Plans	19	24
Negotiate Compromise	9	11
Approve Compromise	1	1

It's important to remember, as you consider these activities, that the outside collectors do not have a carte blanche authority. There are extremely important operational details that must be addressed by anyone entering into such an arrangement. Each state writes a contract with its outside collection agents that spells out such things as limitations, tolerances, calling hours, tone of messages,

training, oversight, supervision, disclosure restrictions, and even the quality of employee. The tax agency will strive to make sure, through the contract, that it has as much confidence in and control over the actions of a non-government collector as it will over its own employees.

Referral Criteria. There is no quick, easy and accurate to summarize the types of debts that are referred to the non-government collectors in terms of age, size, etc. It is however, fair to say that in a majority of states, they tend to be the older, smaller-dollar accounts, perhaps those that are being unworked or that have been unsuccessfully worked inside the tax agency. In other words, the outside agencies tend to receive the residual debt remaining after a variety of actions by the state tax authority.

However, this generalization does not hold in all cases. There are states which have rather extensive programs where the outside collection agencies are considered as a more of a partner in the collection process and even a collector of first resort. You will hear from some of them today. One state will send out a debt as young as 45 days, right after the first notice has been sent. A number of states told us they will refer debts of \$50 to \$100 — and in several cases even \$25. Another state works the debt with in-house personnel only after the collection agency has been unsuccessful in its efforts. For programs of this type, I would suggest that you analyze the use of outside contractors in states such as Michigan, New Jersey, Delaware, and Pennsylvania among others.

The short answer to the question seems to be that a state determines the criteria for referring accounts based on its own internal resources, the age of its technology, the type of tax debt — whether income, sales or business — and generally make a judgment about what makes sense within that scenario.

Collection rates. The differences in approach to the use of outside agents makes it impossible to effectively compare collection rates across states, and detail has not been provided in the materials presented to the Subcommittee. Clearly, the rate of collection has a direct relationship to the quality of debt that is referred. Beyond this, some general observations can be made. For many, the referral actually collected (in dollar terms) — before fees are subtracted — will be in the 5-8 percent range. These numbers will go higher — but probably never reach 50 percent — as a state expands its program and sends to the non-government collector newer and easier-to-collect debts.

I mentioned earlier that the non-government program tends to be small in comparison with the overall collections effort, although there seems to be a trend toward more outsourcing. For both in-state and out-of-state programs, our survey showed that the ratio of total delinquent tax collections by outside agenices compared to all delinquencies ranged from less than one percent to as high as 9 percent. That number will be higher in isolated instances.

Disclosure Issues

These non-government collectors generally have access only to the information necessary to collect the delinquency — the taxpayer's name, address, Social Security number (which is used for account control as well as locating assets and skiptracing), the tax type, and the tax due. Other information may, but not always, be released to the non-government collector at the taxpayer's request. This is usually information necessary to resolve an account dispute. Also, an account collection history may be available to the collector.

There are a few states which routinely give the non-government collectors access to their agency computer files. Those agencies have contracted for a broader scope of taxpayer problem resolution. Those states reported that the non-government collectors are considered agents of taxation, and they are subject to the same disclosure rules as government employees.

In fact, the survey revealed that there are instances in which a contractor is subject to more stringent penalties for unauthorized disclosure of information, or abusive collection practices, than are the state employees. These penalties are usually spelled out as contractual or employment sanctions, but in some 20 states, there are also statutory criminal penalties for abusive or unauthorized practices, and frequently civil penalties and civil actions for damages apply.

Public Perception

Overall, the public seems to have no more problems dealing with non-government contractors as they do dealing with government employees. Seven states reported to us that they have never received a complaint from a government representative, such as a legislator, and another 13 states reported that such complaints were rare. Only five states told us that they received even occasional complaints from legislators and governors — and none reported regular complaints. As for taxpayer complaints, they were rare or occasional; only one state said they were regular.

State Perspectives

Sixteen said the use of a non-government collector was a useful component of their collection program, and an additional 10 states reported their program was very successful. Four states told us they felt their programs were not very successful.

Finally, we asked states what they would tell others who are contemplating these programs. Their comments were quite positive — for instance, these two comments: "We have found collection agencies to be responsive to our needs. They work effectively with taxpayers to resolve the delinquency." And "My experience with private collection agencies has been very positive."

A singular warning message also was revealed: don't underestimate the inhouse staff resources necessary to properly launch and oversee a non-government collections contract.

To quote Arizona, "Tracking payments is tedious, as some are paid directly to the Department of Revenue instead of the agency. Other overhead includes fielding complaints and developing and maintaining systems to refer and update the inventory of assigned accounts."

Illinois warned that the process to change agencies is time-consuming and requires a great deal of intra-bureau cooperation in setting up. Maryland, which has extensive experience, said that developing the interface to and from the collection agency requires extreme planning. Oklahoma called it an "ongoing challenge."

Overall, I believe Oklahoma quite nicely summed up the states' experiences, as revealed in our survey, when it reported, "We feel, however, that the use of an outside agency is appropriate and useful if it is determined ahead of time where such activity fits."

Finally, I will tell you of the seven state agencies that have had a program in the past, and dropped it. One state dropped a 15-year program because elected officials preferred to have the work done by state employees. One upgraded its internal collection functions, and another put the resources it had spent on the outsourced program into internal collections and managed to increase its productivity. Yet another was dropped because of budget cuts. All but one of these programs were solely for the collection of out-of-state taxes.

Conclusion

The survey on state tax agency use of outside contractors for the collection of delinquent tax debts can answer several of the questions the Committee has. In particular, it answers questions on who is using outside contractors, the types of taxes and debts for which they are used, and the types of activities for which outside contractors are engaged. It is also instructive in gauging public perception regarding

the use of outside contractors, eliciting state administrator perceptions on their utility, and highlighting some of the operational concerns that will need to be addressed if they are used at the federal level.

What it does not and cannot speak to is the "economics of delinquent tax collection." By this I mean the relative rates of recovery for various types of taxes, the costs of in-house vs. contracted collectors and the break points for using various types of efforts. The variability among the states simply does not allow complete and accurate comparisons on these issues. For this reason, I would urge that any test of the concept of contrat collectors be carefully designed such that at the "end of the day" the answers the Committee and Internal Revenue Service needs will be available

H.R. 757 - Tax Refund Offset

Introduction

I will turn my attention now to a subject that is of the highest importance to state tax administrators — the question of reciprocal refund offsets.

H.R 757 would establish a program under which the Internal Revenue Service (IRS) and the U.S. Treasury Department could offset or withhold a federal tax refund to satisfy a past-due, legally owing state tax debt. State tax administrators see this issue as a simple, straightforward matter of reciprocity in tax administration between state and federal governments.

The federal government may levy on — essentially, seize — state income tax refunds to satisfy delinquent federal tax debts. The IRS currently is able to exercise its right to levy on state refunds in 32 states and the District of Columbia by working through those states' refund offset programs. This occurs under a cooperative arrangement between the state tax agency and the IRS district(s). States generally are not compensated for these offsets. States collected \$81.68 million for the federal government through their refund offset programs in 1995.

IRS and Treasury do not currently posses statutory authority to reciprocate and offset federal tax refunds to satisfy state tax debts. H.R. 757 would provide such authority by adding the current offset program authorized under I.R.C § 6402 to satisfy debts owed for child support and to other federal agencies an authorization to offset federal tax refunds to satisfy federal tax debts.

Description of Proposal

The proposed legislation would amend IRC § 6402 (the existing federal offset program) by adding a new subsection allowing the Secretary of the Treasury to establish an offset program for legally enforceable, past due state tax obligations. To be eligible for the offset, the delinquency must be one that has been reduced to a judgment under state law and is no longer subject to administrative or legal appeal at the state level. As with other federal agencies, states would be further required to take steps prior to referring the debt to the IRS to notify taxpayers of the obligation and to inform them that such debt will be referred to the IRS for offset if not satisfied in 60 days.

State tax debts would not be satisfied from an offset until all federal tax debts, assigned child support, non-assigned child support and debts due other federal agencies were satisfied. The Secretary could charge the states for the costs of the offset program in the same manner as other federal agencies are charged.

¹ There are 41 states, including the District of Columbia, with a broad-based individual income tax. Included in the 32 states with an offset program for federal tax debts is Alaska, which has no individual income tax. It does, however, have a unique state refund program that works in a similar manner.

Once an offset is made, taxpayers could still protest the amount due. The legislation also contains provisions allowing a joint federal refund to be split among both spouses if only one spouse owes the state tax debt. The legislation would also amend IRC § 6103 to permit the disclosure of information regarding the offset to state tax agencies when necessary.

History of Proposal

Rep. Andrew Jacobs (D-Ind.) and Rep. Jim McCrery (R-La.) introduced H.R. 4138 in the 103rd Congress. The House Ways and Means Subcommittee on Select Revenue Measures held a hearing on H.R. 4138 in October, 1994. Treasury formally voiced its support for the proposal.

Rep. Jacobs along with Rep. McCrery and Rep. Moran introduced the bipartisan H.R. 757 in February, 1995. Senator Orrin Hatch along with Sen. Conrad introduced the bipartisan S. 1408 in November, 1995. The bill was included in a package of miscellaneous tax proposals considered by the House Ways and Means Committee in July, 1995, when Treasury again said in written testimony that it had no objection to the provision.²

Neither during the hearings nor at any other time has the bill encountered opposition from any official or organization.

Reasons to Support H.R. 757

There are several reasons supporting passage of H.R. 757:

- The issue is simply one of reciprocity in tax administration. The legislation does
 nothing more than allow states to participate in an existing federal offset
 program and allow the IRS to reciprocate for what the states are already doing on
 behalf of the U.S. government, an effort which returns from \$50-\$100 million
 annually to the U.S. Treasury.
- These tax delinquencies which would be subject to the program have already
 completed all available protests and appeals within the state, i.e., taxpayers have
 exhausted or foregone available legal protests of the tax debt. Beyond this, IRS
 procedures require that taxpayers be given on additional specific notification
 before any offset occurs.
- IRS would be paid for its expenses, even though states seldom require the federal government to pay for its participation in their programs.
- Offsetting for state tax debts would not cannibalize any existing program because state tax debt would not be satisfied until all other currently authorized federal offsets are satisfied.
- Offsetting federal refunds for state tax debts will be an effective method of
 collecting delinquent debts owed the states. The Federation of Tax
 Administrators (FTA) estimates that a federal offset program could increase state
 receipts by about \$150 million to \$200 million annually in the early years of a
 program and by somewhat lesser amounts as the current inventory of
 receivables is reduced.
- A reciprocal program would also be expected to increase federal receipts because
 it is anticipated that the remaining income tax states would begin to offset for the
 federal government in order to participate in the IRS offset (except in any state
 where the Secretary of Treasury chooses to not have federal debts offset). The
 Joint Committee on Taxation has estimated that reciprocal refund offset
 legislation would benefit the federal government by some \$8 million.
- To the extent that refund offsets cost-effective way to collect debts are an effective debt collection tool, there is no reason why the state-federal program should not

² The Treasury Department did indicate that there were several technical concerns it wanted to address in the final version of the legislation. These technical issues have been addressed in S. 1408 as introduced by Sens. Hatch and Conrad. Reference continues to be made here to H.R. 757 in interests of simplicity, but the changes incorporated in S. 1408 should be included in any final legislation. An explanation of the changes made between H.R. 757 and S. 1408 will be provided to the Subcommittee.

be fully reciprocal. The principal policy issue surrounding refund offsets has been whether they affect voluntary compliance. If they do, the federal government should stop offsetting its debts against state refunds; if not, it should allow reciprocal offset of state debts against federal refunds. By making permanent the federal refund offset programs for child support and student loans, Congress has made the policy judgment that offsets are an effective collection tool that should be used. We agree.

This measure has been aired before two hearings and has never received any
public or government objections. The U.S. Treasury Department and IRS
support the proposal.

The Nonresident Issue

Some concern has been expressed about using the refund offset mechanism to collect state tax debts owed by nonresidents of a state. We would urge the Committee to reject this notion and not place conditions on the types of state tax debts which could be satisfied under the program. We take this position for several reasons

- To deny the applicability to tax debts of nonresidents is to suggest that all income
 taxes imposed on nonresidents are in some sense illegitimate. Nothing could be
 further from the truth. The U.S. Supreme Court has for 75 years sanctioned the
 levy of state income taxes against nonresidents who earn income within a
 particular state provided that certain tests of due process and equity are met.
- The Committee should remember that before any debt is referred to the offset program it will have been reduced to a legal judgment against the taxpayer in the state, meaning the taxpayer must have been accorded significant opportunities to protest and otherwise resolve the delinquency. In addition, before a debt is certified to the offset program, the taxpayer will have received one additional notice at the latest address contained on a federal tax return.
- The large majority of tax debts owed by nonresidents are very likely to have been
 accrued while the individual was a resident of the state. That is, experience
 shows that many nonresident debts are owed by persons who were former
 residents of the state, but have subsequently moved to another state.
- This is a matter of reciprocity in tax administration, not tax policy. If Congress is
 concerned about particular tax policies of the states, it should address those issues
 directly on their merits and not in a back-door fashion by denying the use of
 effective, legitimate collection tools.

Conclusion

This is a noncontroversial measure whose time clearly has come. We greatly appreciate the work of Reps. Jacobs and McCrery in drafting and sponsoring H.R. 757, as well as the support for the bill of the Treasury Department, especially the Internal Revenue Service. We appreciate the time they have devoted to drafting a bill that is acceptable to them. Federal-State cooperation in tax administration is increasing rapidly, and enactment of this bill would be a welcome step towards increased interdependence. State tax administrators urge you to take all necessary steps to assure that this legislation is included in the next available bill.

Federation of Tax Administrators 444 North Capitol Street, N.W., #348 Washington, D.C. 20001 Ph. (202) 624-5890/Fax (202) 624-7888

Responses to FTA Survey B-10/96, Private Collection Activities

- Detail is given where provided by the state.
- "CA" refers to the California Franchise Tax Board, which collects income taxes for the state.
- The California Board of Equalization is designated as BOE; that agency is responsible for administering sales and other taxes in California.
- On the question of how the contractors' fees are determined, answers of "contingency fee," "percentage of dollars collected," and "commission" and "sliding fee commission" have been placed into the same category entitled "contingency."
- Responses from states that do not have a current contract have been compiled separately and are at the end of the survey.
- Certain additional details and analyses provided by the states are attached.
- On the question of how accounts are selected for referral, answers are compiled so as to assist the reader in following all the criteria required by each individual state. Thus, the matrix is somewhat spread out.
- On the question of volume, Oregon's answers were given based on monthly volume; the answers have been multiplied by 12 to arrive at an approximated 12-month annual figure.
- The responses to questions about gross recovery rate are not given because respondents do not track that statistic in a consistent manner, and because the answer is heavily dependent upon the type of debt referred.

Private Collection Activities RESPONSES FROM STATES WITH A CURRENT PROGRAM

1. Do you use private or non-government agents in the collection of delinquent taxes? What year did the program begin?

AZ (1987), AL, CA1 (1986), CO (1988), CT, DE (1981), HI (11-95), IA (1983), IN (1983), KS (1-96), KY (1986), FL (1986), ID (1970), IL (6/84), LA (11-90), ME (3-84), MD (1986), MA (1983), MI (1985)2, MN (1977), MO (1984), MS (1988 & 1994)2, MT (1975), ND (1976), NE (1982), NJ (1993 deficient, 1995 delinquent), OK (11/94), OR (1983), OH (1986), PA (1975), SC (1987), TN (2-93), UT (June 1995), VA (1986), VT (1991)*, WA (1992), WI (1982), WV (1989).

Texas does not have an outsourcing program per se, but it does have a contract with a temporary employment service that supplies personnel to staff the state's Automated Collections Center. Details are attached.

2. How are referrals currently made to your outside "collection agent"?

By this agency only AZ, AL, CA, CT, DE, HI, IA, IL, IN, KY, LA, ME, MD, MA, MN, MO, MS, MT, ND, NE, NJ, OK, OR, OH, PA, SC, TN, UT, VA, WA, WI, WV

From another contractor (No responses)

3. What types of outside "collection agents" do you use? Check all that apply.

Independent attorneys

IN, ME, OH

Private collection agencies

AZ, AL,CA, CT, DE, HI, IA, IL, IN, LA, ME, MD, MA, MN, MO, MS, MT, ND, NE, NJ, OK, OR, OH, PA, SC, TN, UT, VA, WI, WV

Firms of a certain size or related criteria (please specify)

DE

MA (experienced and capable of handling large volumes of accounts)

WA (nationwide)

Skip tracing service specialists (no responses)

Other (specify)

AZ Attorney General for high-dollar balances and accounts that may be litigated. ME County Sheriff Association, mailing service for certified mail, in-house collectors that work with the state employees.

IN Sheriffs within each county that they serve also collect taxes for the state. MO Prosecuting attorneys.

4. If you use private collection agencies, do you require that your accounts be worked by a dedicated team (as opposed to a private collection agent collecting retail debts and delinquent taxes during the same shift)?

Dedicated team required IL, MA, MO, MS, NJ, OH, PA,

We have no such requirement

AZ, AL,CA⁵, CT, DE, HI, IA, IN, LA, ME, MD, MN, MT, ND, NE, OR, SC, TN, VA, WA, WV

We have no such requirement, but that is how our accounts are worked anyway UT, WI

¹ See additional explanations for California FTB attached.

² Currently developing a modified ACS system RFP. There will be significant changes to the existing structure of private sector involvement.

3 Out of state account.

Out of state accounts only began in 1988 and expanded to a full-time procedure on Jan. 1, 1994. ⁴ We have recently passed legislation to allow outsourcing of all tax types. Prior to this year, in-state income accounts were completely off limits and business taxes were limited to trust taxes more than 540 days old.

⁵ Note, however, that collection agency staff are prohibited from using state information in the collection of non-state debts.

In-State Accounts

Out-of-State Accounts

5. For which taxes do you use non-government collectors?

	Individual Income	CA, HI, IA, IL, ME, MD, MI, MN, OK,OH, UT,	CA, HI, IA, IL, MD, MI, MN, MS, ND, OK, OH, UT,
	Business Income	IA, IL, MI, MN, OH	CA, IA, IL, MN, MI, ND, OH
	Sales / gross receipts	IA, IL, ME, MI ⁴ , MN, OK,	FL, IA, IL, MS, MN, ND, OK, WA
	Excise		WA
	All tax types	AZ, CT, DE, KS, IN, MA, MO, MT,NJ, OR PA, SC, VA, WI, WV	AZ, AL ⁷ , CT, CO, DE, ID, IN, KY, LA,ME, MA, MO, MT, NJ, NE, OR, PA, SC, TN, VA, VT, WI, WV
6.	For which of the following	activities do you currently us	e private collection agents? Out-of-State Accounts
	Skip tracing	In-State Accounts CA, DE, HI, IA, IN, MD,MO, MT, NJ,	AL, CA, DE, HI, IA, IN, LA,MD, MO, MT,
	OR, OH,PA, SC, UT,		PA, SC, UT, VA, WI, WV
	Collection letters	AZ, CA, CT, DE, HI, IA, IN, MD, MA,MO, MT, NJ,OK, OR, OH, PA, SC, UT, VA, WV	AL, AZ, CA, CT, DE, HI, IA, IN, LA, MD, MA, MS, MO, MT, NJ, OK, OR, OH, PA, SC, UT, VA, WV
	Collection calls	AZ, CA, CT, DE, HI, IA, IN, ME, MD, MA, MO, MT, NJ OK, OR, OH, PA, SC, UT, VA, WI, WV	AL, AZ, CA, CT, DE, HI, IA,IN, LA, ME, MD, MA,MO, MS, MT, ND,NJ, OK, OR, OH,PA, SC, UT, VA, WI, WA, WV
	Face-to-face visits	CA ⁴ , MD, MT, PA	CA, LA, MD, MT, ND, WA
	Receiving Payments	AZ, CA, DE, HI, IN, IA, MD, MA, MT, OK, OR, NJ, SC, UT, WI, WV	AZ, CA, DE, HI, IN, IA, LA, ME, MD, MA, MS, MT, ND, OK, OR, SC, UT, WI, WA, WV
	Lockbox services	MT	MT
	Asset location	CA, DE, IA, MT, OR, UT, WI	CA, DE, IA,LA, MT, TN, OR, UT, WI

Other

NE: Processes as necessary to collect delinquencies (out of state)

IL: Collection of referred accounts, both in-state and out-of-state.

TN: All collection activities after the state has declared an account non-collectible.

Also uses non-government collectors for state agency debts.
 Except ad valorem
 While all of the listed activities are permitted, face-to-face visits are believed to occur only rarely.
* Contract related only

What activities or co	percive actions are your outside		
	In-State	Out-of-State	Subject to
Litigation	Accounts CA, DE, HI, IA, IN, MT,MN, PA, WI,	Accounts CA, DE, HI, IA, IN, LA, MT, MN,	These Limits AL ¹⁰ , IN ¹¹ ,
		MS, NE, PA ² , ND OR, WA, WI	LA ¹³ IA ¹⁴ MT ¹⁵ CA ¹⁶
			OR ¹⁷ W I ¹⁸
Telephone dunning	AZ, CA, CT, DE, HI, IA, IL, IN, MA, ME, MD, MN, MO, MT, NJ, OK, OR, OH, PA, SC, UT,	AZ, AL, CA, CT, D HI, IA, IL, IN, MA ND, ME, MD, MS, MO,OK, OR, MT, N OH, PA, SC, UT, T	, NE, MIN, NJ,
	VA ¹⁹ , TN, WI, WV	VA, WA, WI, WV	
Asset seizure	DE, MT, TN, UT,	CA. DE, MT, ND, NE, UT, WA	DE UT ²¹
Issuing liens/levies	DE, MT, NJ, OR, SC, TN	DE, MT, NJ, OR, W	
Wage garnishment	IN, MN, MT, OR, SC, TN, UT,	IL, IN, MN, NE, N MT, OR, UT, WA,	UT
Negotiating payment plans	AZ, CA, IL, DE, HI, IN, IA, MA, ME, MD, MO, MN, MT, NJ, OK, OR, OH, PA, SC, TN, UT, VA, WI	AZ, AL, CA, HI, IA IN, DE, LA, MA, M NE, MD,MO, MT, NJ, ND,OK, OR, O SC, VA, UT, WA,V	E, MN, H, PA,
Approving	AZ, CA, IL, DE, IN,	AZ, AL, CA, IL, DI	
payment plans	MA, MÉ, MD, MN, MO, MT, NJ, OK, OR, OH, PA, UT, VA, WI	IN, LA, MA, NE, ME, MD, MN, MO, NJ, OK, OR, OH, ND, PA,UT, VA, WA, WI	UT ²³
Negotiate compromises	DE, IA, MN, MO, MT,PA, SC, TN, WI	DE, IA, NE, MO, MT, ME, ME, I PA, SC, WI	DE MN,
Approve compromises	PA	PA	MN

Requires prior approval
 With written approval from the state
 Detail of limitations is attached.

With Department approval and Attorney General approval.

Prior approval

¹⁵ Must contact and we assign debt to

Must contact and we assign debt to
 Occurs rarely and requires approval
 Requires Attorney General approval.
 Subject to the state's approval; in-state litigation is hardly ever used.
 Activities for in-state accounts have been done in the past on a pilot basis only, but full implementation of in-state delinquent account collections by private contractor will begin in July 1996.
 State approves of calling hours and days
 With prior approval and expenses paid from the standard collection fee; same limit applies to wage garnishments.
 To be paid off within 12 months.
 Up to 12 months

How do you assign or select accounts for referral: 8. (a) of IN-STATE ACCOUNTS.

Age				
Indiv.	Business	Sales/	Excise	All tax types
income	income	gross receipts		
HI > 1 year				IA > 120
IL > 6 mos	IL >1 yr	IL >1 yr		IN
MO 7-9 months	MO 7-9 months	MO 9-12 months	MO 12 mos	DE >120 days
ME 1 month				OR
MA >120 days	MA >120 days	MA >120 days	MA >120 day	/s MA >120 days
MN > 90 days MT > 2 ²⁵	MN > 90 days	MN > 90 days		NT 45 1 - 26
OK > 6 months		01/2 / 2 11 2		NJ 45 days ²⁴
	OU 42	OK > 6 months		PA 2-3 yrs
OH < 3 years VA > 2 years	OH < 3 years VA > 2 years	VA > 2 years		SC > 2 years WI > 3 years
UT 2 years	VA > 2 years	VA > 2 years		W1 > 5 years
OI 2 years				
Dollar amount (g	reater or less than	?)		
Indiv.	Business	Sales/	Excise	All tax types
income	income	gross receipts		• ,
				AZ > \$50 < \$50
$CA^{27} > 100				CT > \$500
HI < \$5,000				IA <\$500
IL > \$ 50	IL >\$50	IL > \$50		DE >\$501.
		ME <5,000		MO \$25; OR,
1// 4/0.000	144 4400	MT > \$100		
MA <\$10,000	MA >\$100	MA >\$100	MA >\$100	MA >\$100
MN > \$25 NI \$25	MN > \$25	MN > \$25		SC
OK > \$50	NJ \$200	OK > \$50		PA \$100,000
OH < \$25	OH < \$25	OK > \$50		VA > \$25
UT \$25-\$1,000	011 (122)			WI > \$50 ²⁸
WV < \$500		WV < \$1,000		111 > 450
		177 4 41,000		
If skip-tracing is:	required			
Indiv.	Business	Sales/	Excise	All tax types
income	income	gross receipts		
CA ²⁹ , HI,	IL, OH	IL		IA, IL, IN,
IL, OH UT				MO, MT, NJ,
				OR, PA, SC,
				VA,
				WI > 3 years
If not being work	ed in-house (unwor	ked accounts)		
Indiv.	Business	Sales/	Excise	All tax types
income	income	gross receipts		
		,		AZ ³⁰ , IA,
CA, HI, OH	OH			IN, MO, MT,
				ME >2 years
MA <\$10,000	MA >\$100	MA >\$100	MA >\$100	MA >\$100
OK, UT		OK		NJ, SC,
WV <\$500				VA

²⁴ 70 percent of the accounts referred are older than one year outstanding: 30 percent of the accounts referred are less than one year outstanding.
²⁵ Montana assigns all accounts over \$100.

Montana assigns all accounts over \$150.
 After first notice
 The referral criteria indicated are applied only to accounts with projected cost/benefit ratios insufficient to be worked in-house. See cover for discussion.
 \$250 if this is a second placement.
 No distinction is made between cases on the basis of whether or not skip-tracing may be required.

Within limits

Indiv.	Business	Sales/	Excise	All tax types
income	income	gross receipts		
HI. IL	IL	IL		
MD >\$100				AZ, DE, IA, IN.
				MO, MT, OR,
MA >\$100	MA >\$100	MA >\$100	MA >\$100	MA >\$100
OK, OH,	OH.	OK		PA, SC, VA
UT	··.,	0.1		WI > 3 years
••				WV

Other: New Jersey deficiencies go to a private vendor first; they flow in-house if ${\it unsuccessful}$.

8 (b) OUT-OF-STATE ACCOUNTS

Age				
Indiv.	Business	Sales/	Excise	All tax types
income	income	gross receipts		•
HI > 1 year,		-		
IL > 6 mos.;	IL > 1 year;	<pre>IL > 1 year;</pre>	_	DE > 120 days;
ME 1 month;				IA > 120 d;
MA >120 days	MA >120 days	MA >120 days	MA >120 days	s MA >120 days
MO 7-9 months	MO 7-9 months	MO 7-9 months	MO 12 mos.	IN
MT > 2 years				NJ
MN > 90 days	MN > 90 days	MN > 90 days		
ND 6 months	ND 6 months	ND 6 months		
OK > 6 months		OK > 6 months		OR
OH < 3 years	OH < 3 years			PA 2-3 years;
				SC > 6 months
VA > 2 years	VA > 2 years	VA > 2 years		TN 90 days
UT \$25		WA < 10 years		WI (any age)
wv	wv	wv		
Dollar amount (greater or less than	?)		
Indiv.	Business	Sales/	Excise	All tax types
income	income	gross receipts		3,
		,		AZ > \$50
CA > \$100	CA > \$100			IN \$25
HI <\$5,000				IA <\$500
IL > \$50	IL > \$50	IL > \$50		DE >\$501
		ME <\$5,000		MO \$25;
MA <\$15,000	MA >\$100	MA >\$100	MA >\$100	MA >\$100
MN > \$25	MN > \$25	MN > \$25		
OK > \$50		OK > \$50		NE >\$200
OH < \$25	OH < \$25	MT > \$100		NJ
UT				OR,
				PA \$100,000
				SC, VA > \$25
				WI > \$50/\$250
If skip-tracing is Indiv.		Calaat	Poster	40
income	Business income	Sales/	Excise	All tax types
income	income	gross receipts		AT TA
HI II OH	IL, OH,	IL		AL, IA,
HI, IL, OH, UT	il, On,	iL.		IN, NE, NJ,
01				MO, MT, OR, PA, SC, VA
If not being wor	ked in-house (unwo	rked accounts)		ra, sc, va
Indiv.	Business	Sales/	Excise	All tax types
income	income	gross receipts		· · · · · · · · · · · · · · · · · · ·
		,		AZ31, IA,
CA, HI, MN,	CA			ID, IN, MO,
MA <\$100	MA >\$100	MA >\$100	MA >\$100	MA >\$100
OK, OH, UT	OH,	OK		MT,
	•			NE: All accts
				NJ, OR, SC,
				VÄ

³¹ Within limits

If in-house persor	nel were unsucce	ssful		
Indiv. income	Business income	Sales/ gross receipts	Excise	All tax types
		•		AL, CT, DE,
HI, IL, MN, UT	CA, IL, MN	IL, MN		IA, IN, LA ³² ,
				MO, MT, NE
				NJ,
				ME >\$2,000
MD > \$100				OR, PA
ND	ND	ND		
OH, UT	OH,	WA	WA	SC, VA, TN

Mississippi - The Collection Division is responsible for the research and collections of delinquent accounts when the taxpayer is a nonresident of Mississippi and/or the taxpayer has assets or employment outside the state. After all reasonable in-office collection procedures have been exhausted and it is determined that there are no assets in Mississippi, then it is turned over to the out-of-state collection private agency.

9. If available, please provide us with your volume.

Results are: accounts referred / dollars collected /

Percentage of total delinquent collections to contracted collections

In-State	Out-of-State	Both (combined)
AZ 7,203	AZ 5,326	AZ 13529/\$1,146,401/0.8%
	AL 736/\$44,432/0.26%	CT 5,542/\$226,350/5%
CA 24,000/\$1,219,000/0.09%	13	HI 4,000/\$147,000/3%
	CA 24,000/\$4,527,000/0.32	%
		IA 13,123/\$851,412/5%
IN \$ 18,123,081	LA 1,412/\$242,149 ³⁴	OK 54,421/\$5,571,485
ME 23,000/\$9.7 mil	ME 3,000/\$1.3 mil	ME 24% (not broken down)
NJ 67,829/\$26 million/42%36		MO 49,000/\$7.1/7.8%
		MN 1,528/\$2,775,000
OR 2,400/\$162,000/6%	OR 3,600/\$384,000/16%	
OH 100,000/<\$1 million	OH 2,500	DE, 12,258/\$11 million/9%
SC4 32,560/\$2.7 mil/2%	SC 1,504/\$410,000/9%	IL, 40,702/\$3,187,396/0.06%
UT 3,316/\$124,743	UR 3,953/\$248,719	UT 11 % (not broken down)
	WA 1,027/\$440,371/0.04%	
WI 2,600/\$66,000/<1% ³⁷	WI 5,000/\$1.5 mil/1-2%	MD 53,536 ³⁴ /\$7,500,500
WV 12,000/\$1.256 mil/16%	ND 393/\$133,115/3.87%	MA 66,111/\$9,037,770/5.57%
		MS 1,098/\$310,845
		MT 5,000/\$4 million
		NE 103/\$19,952/0.122%
		PA 3,813/\$187,125/2.3%

VA: Beginning July 1997 we anticipate placing approximately 12,000 accounts per month for 18 months, after which volume should decrease to approximately 3,000 per month.

¹² No assessments are placed, only returns, non-sufficient funds (bad checks) and audits.

³⁵ For California's FTB, the percentage refers to the percentage of contracted collections to total delinquent tax collections, rather than percentage of total delinquent tax collections to

contracted collections.

**Accounts assigned are accounts placed in "uncollectible status." The total collections from all department billings was \$144 million for FY 1994-95.

**S 42 percent of total dollars collected, 65 percent of total collection adjustment (cases closed).

³⁴ Figures are for the year ending Feb. 1996

³⁷ Figures are for six months because the in-state program began only last year.

³⁴ This number represents the number of periods referred; the percentage is not available, but the total amount of delinquent tax collected for FY 95 included dollars collected by collection agencies was \$89.7 million.

10. How do you determine the payment to your outside collection agent?

Contingency fee AL, AZ, CA, CT, HI, IA, IL, IN, LA, ME, MA, MN, MO,

MS, MT,NE, ND, OK, OR, OH, PA, SC, VA, WA, WI,

W۷

Hourly rate ME, NJ

Other:

DE Based on contract

ME Flat fee per bounced check collected

MD Commission of dollars collected

MS 33 1/3 added to the total tax liability (tax, penalty and interest)

TN Fee added to amount of tax, penalty and interest owed

11. Do your provide the outside collectors with access to taxpayer returns or other information (other than delinquent amount, tax type, and basic identification information)?

No AZ, AL, CA, CT, HI, IL, IN, MD, MS, MT, OR, TN, UT, VA, WI, WV

Yes. IA, LA, ME, MA, MI, MO, NE, NJ, ND, OK, OH, PA, SC, WA

Detail given by "no" states: AZ: Account number, tax type, balance, name, address - no confidential information. DE: If requested/authorized by taxpayer; HI: name, address, social security number, years delinquent, and amounts delinquent; MD: SS, name, address, phone number, tax, interest and penalty by tax period; IL: Tax type, delinquent amount and basic identification information; IL, base tax, penalty, interest and damages, general info on warrant; OR: collection history notes, billings, last known address; AL: name, last known address, telephone number, social security or FEIN number, assessment date, amount due, period covered, type of tax, and lien date.

Detail given by "yes" states:

1A: When necessary to resolve account, state tax information only. If amount due resulted from adjustments from federal audit, that information is NOT available to the collection agency.

LA: When requested by the taxpayer, information needed to verify the liability.

ME: Most individual income tax is privatized; they do problem resolution as well as collections. Other collectors can get any information needed to settle or collect the case. MA: If taxpayer disputes the delinquency we will inform the outside collector of the reason for the delinquency; they will inform the taxpayer.

MO: Automated collection system gives account collection history

MN: In litigation, and to substantiate amounts per taxpayer request.

NJ: Routine collection process allows access to Division Computer Systems and other taxpayer information as required. As agents of taxation, they have the same access as Division employees.

NE: On request of the outside collector, the taxpayer returns that created the liability (will be) assigned to the outside collector.

ND: Copies upon rquest of all information.

OK: Information is provided at the department only - there is no on-line access. Available are copies of returns and assessments.

OH: Access is provided to the returns if the taxpayer sends them to the outside collector to adjust an estimated assessment; the information is that provided on the tax return. PA: Criminal profiles, corporations merging, taxpayer's request, etc. (even then limitations

exist); information depends on the type of case and the restrictions.

SC: The collectors have in-house personnel and have access to any application or return information. Ourside collectors are subject to the disclosure rules within the agency.

Returns require written taxpayer approval; available also are all collection notes, documents and lien information.

RESPONSES FROM STATES THAT DO NOT HAVE A CURRENT PROGRAM

1. Do you use private or non-government agents in the collection of delinquent taxes?

No

Alaska, Nevada, New Hampshire, Wyoming

Considering implementing

GA (finalizing RFP; responses are based on plans.)

NY (considering the use of collection agencies for follow-up on cases which have gone through the collection process and have been determined to be currenly not collectible.)

Have had a program in the past

AK (1986-88) Ceased participation because we upgraded our internal collection function. Calif. BOE (1986-88). Ceased participation because recovery amount was minimal and private colletor elected not to renew the contract.

(early 1980s). Program was in effect for a very short time and was not successful.

NY (1981-1989). Contracts were terminated in 1989 and have not been renewed.

NC. Ceased participation because of budget cuts.

NM Ceased participation because of low return on investment.

RI. Have used a private collection agency but only in very lmited circumstances. We only engaged the agency for taxpayers who ere located out of state and had no in-state assets. In addition, we did not refer those cases until we had made attempts to collect ourselves and only after the matters were reduced to judgement in our courts. We never referred more than a handful of cases and the collection agency was not successful in the matters referred. As a result the practice has been dropped over the years.

SD (1980-1995). Ceased participation because the Governor decided to perform the work with government agents.

- 2. How are referrals currently made to your outside "collection agent"? (no responses)
- What types of outside "collection agents" do you use? Check all that apply. Private collection agencies

ΑK

BOE

GA

Firms of a certain size or related criteria (please specify)

NY (those that provided full service operations, including skip-tracing, asset location, dunning and collection contact, and the ability to retain outside counsel for litigation efforts related to assigned cases.)

4. If you use private collection agencies, do you require that your accounts be worked by a dedicated team (as opposed to a private collection agent collecting retail debts and delinquent taxes during the same shift)?

Dedicated team required

GA

We have no such requirement

ROF

Other: NY did not require a dedicated team but at least one of its agencies did assign certain members of its staff to work exclusively on the tax collection cases.

12. Other than the federal Fair Debt Collection Practices Act, what protections and sanctions could apply if there were an unauthorized disclosure of taxpayer information or abusive collection practices?

Statutory criminal penalties	By the Private Collector AZ, AL, CA, HI, IL, IA, ME, MA, MO, MT, NE, ND(ud)** OK, OR, TN,	By a State Tax Agency Employee AZ, AL, CA, HI, IL, IA, MA; ME,MO, MT, NE, NJ, ND(ud), OR,
	UT, VA, WI, WV	TN, UT, VA, WI,
Civil penalties	AZ, CA, IL, MA, MN, MO, MT, OR, ND (ud), OH, PA, VA, TN, WA,	AZ, CA, MA, MN, MO, MT, NJ,OR, VA, ND (ud), WA,
Civil actions for damages	AZ, CA, IA, MA, MN, ND (ud/a [©]) MO, OR OH, PA, UT, VA, TN, WA, WV	AZ, CA, 1A, MA, M, MN, MO, NJ, OR, ND (ud/a), TN, UT, VA,WA,
Contractual or employment		
sanctions by your agency	AZ, AL, CA, DE, IL, LA,ME, MD, MA, MN, MO, OR, ND (ud/a), OH, PA, SC, TN, UT, VA, WA, WI, WV	AZ, AL, CA, DE, IA, ME, MD, MA, MN, MO, MS, NJ, OR, OH, PA, VA, TN, WA, UT, WI, ND (ud),
Other (please specify)		

OK: Immediate dismissal

of employee upon request OK

LA: Required by the contract to comply with state statute LRS 47:1508

NJ: State tax uniform procedures, Treasury Code of Ethics, private vendor sanctions, IRS Code of Ethics.

13. What has been your frequency of complaints about outside collectors?

	From Taxpayers	From Government (Legislators, etc.)
Never		AL, CT, LA, MS, OR TN, WA,
Rarely	AL, DE, ME, MD, MO, MN, NE, TN, WI,	AZ, DE, IA, ME, HI, IN, MN, MO, OK, PA, SC, UT, WI,
Occasionally	AZ, CA, CT, HI, IL, IA, IN, LA,MA, MS, MT, ND, OK, OR, OH, PA, UT, SC, VA,	CA, IL, MA, OH, VA,
Regularly	WA	

14. Overall, how do you judge the success of your outsourced collection program?

Not very successful AZ, AL, MT, TN

CA, CT, HI, IA, IN, LA, MD, MA, MS, NE, A useful component

OK, OR, VA, WA, WI (moreso out-of-state), WV

DE, IL, ME, MN, MO, ND, OH, PA, SC, UT Very successful

For unauthorized disclosure
 (a) For abusive collection practices

- 15. Has your experience yielded any benefits, problems, or issues that you would wish to share with others?
- AZ: Tracking payments is tedious, as some are paid directly to the Department of Revenue instead of the agency. Other overhead includes fielding complaints and developing and maintaining of systems to refer and update inventory of assigned accounts.
- AL: Over the past 11 years, the Alabama Dept. of Revenue has used two private collection companies to collect out-of-state accounts only. However, all efforts are exhausted to collect these accounts in-house prior to making a referral. Since we have a minimum collection statute of 10 years, many of the accounts are already very old when a referral is made. This factor contributes greatly to the low gross recovery rate.

DE: Information attached.

- IL: Should award more than one-year contract. The process to change agencies is timeconsuming and requires a great deal of intra-bureau cooperation in setting up.
- ME: We have at least six various contracts for different types of enforcement/collections. Each is very different, which makes it impossible to fit the contract results in to your survey.
- MD: Developing the interface both to and from the collection agency requires extreme planning.
- MA: The highest recovery rate lies within the primary accounts. Obviously, the older the "paper" the less the success rate of recovery. New accounts assigned as early as possible prove to be the most fruitful.
- MN: We are working on giving on-line access to our collection system. This will benefit us and the agency. We are collecting money that may not otherwise have been collected.
- MO: We have found collection agencies to be responsive to our needs. They work effectively with taxpayers to resolve the delinquency either by payment or obtaining documentation to resolve the account.
- NE: The accounts are worked quite extensively before they are referred so the recovery is not as great as it might be if they were referred sooner.
- ND: My experience with private collection agencies has been very positive in the past 23 years. Two of the main reasons are because the two state employers I have worked for emphasized background scrutiny nd references to ensure that the private collector hired lived up to claims of competence. The other reason for success has been the intense education provided the private collector's staff, which enables them to pursue complex liabilities with confidence, which results in increased success.
- OK: Integrating the private collection agency into the overall collections process is an ongoing challenge. We feel, however, that the use of an outside agency is appropriate and useful if it is determined ahead of time where such activity fits.
 - PA: No problems or issues; good rate of recovery is the benefit.
 - SC: bankruptcies tend to be a big problem.
- UT: Referring our "older" delinquent accounts to a private collector allows our in-house collectors to focus on collecting new liabilities and increasing compliance. Also, the agency we contract with has the ability to locate taxpayers using an automated collection system which we don't currently have. Our skip tracing resources are minimal and the cost of developing our own automated collection system which would include a skip-tracing function is prohibitive. Using a private collector is a very useful component of our collections program.
 - WV: It has enabled us to concentrate our collection efforts to high dollar delinquencies.

5. For which taxes did you use non-government collectors?

Individual Income	In-State Accounts AR	Out-of-State Accounts AR
Sales / gross receipts		BOE
All tax types		GA NC NY (however, tried to exclude certain types of assessments issued for nonfiling of corporation franchise tax returns, based on the experience that these were relatively non-renumerative cases.)

6. For which of the following activities did you use private collection agents?

Skip tracing	In-State Accounts	Out-of-State Accounts BOE GA
Collection letters		BOE GA
Collection calls		BOE GA
Face-to-face visits		вое
Receiving Payments		BOE GA
Asset location		BOE

7. What activities or coercive actions are your outside agents permitted to take? In-State Out-of-State Subject to Accounts BOE These Limits Accounts Litigation GA Telephone dunning BOE GA Negotiating BOE pmt plans BOE Approving pmt plans GA

New York: Contracts provided that the agencies would make contact, by mail or telephone, with debtors to collect the debt through payment demands or short-term payment arrangements. Agencies unable to collect through these means could also request litigation of individual cases where recovery prospects seemed promising. If the state approved litigationthe collection agency would initiate suit in the debtor's home state. Agencies were not authorized to negotiate contracts, but they were permitted to recommend penalty waiver under "relaxed" criteria to facilitate debt recovery.

8. 8(a) in-state accounts - no responses

8 (b) referral of OUT-OF-STATE ACCOUNTS

	Sales/	All tax types
Age	gross receipts	GA (>2 years)
Dollar amount		GA
If skip-tracing is required		
If not being worked in-house		GA
		GA NC
If in-house unsuccessful	BOE	GA
	BUE	NC NC

New York: Out-of-state accounts for any tax type where the balance was greater than \$100, excluding the corporate tax, withholding tax delinquency assessments (eg, failure to file). For higher balance cases (the threshold varied), cases were not assigned unless state staffers had worked the cases to completion. No bankruptcy or protest cases were assigned.

9. If available, please provide us with your volume.

NC: Out-of-state, 25 percent

- 10. How did you determine the payment to your outside collection agent?

 Contingency fee AR, BOE, GA, NY (17 to 30%), NC
- 11. Do your provide the outside collectors with access to taxpayer returns or other information (other than delinquent amount, tax type, and basic identification information)? No AR, BOE, GA, NC

Yes NY (warrants filed; other information only when approved litigation required certified copies of basic documents to substantiate the liability.)

12. Other than the federal Fair Debt Collection Practices Act, what protections and sanctions could apply if there were an unauthorized disclosure of taxpayer information or abusive collection practices?

Statutory criminal penalties	By the Private Collector BOE, GA, NY	By a State Tax Agency <u>Employee</u> BOE, GA, NY
Civil penalties	AR, BOE, NY	AR, BOE, NY
Civil actions for damages	BOE	BOE
Contractual or employment sanctions by your agency Other (please specify)	BOE, GA	BOE, GA

13. What has been your frequency of complaints about outside collectors?

	From Taxpayers	From Government (Legislators, etc.)
Never		BOE
Rarely	BOE	AR, NC
Occasionally	AR, NY, NC	
Regularly		

14. Overall, how do you judge the success of your outsourced collection program?

Not very successful

NY (useful at first but less productive as state workers became

more proficient at collecting out-of-state accounts)

A useful component

Very successful

15. Analysis of the program

NY: A study in 1989 suggested termination of the contracts in favor of utilizing resources to supporting in-house efforts. As a result, out-of-state collections increased from \$1.4 million in 1988-89 to \$10.2 million in 1990-91.

16. Has your experience yielded any benefits, problems, or issues that you would wish to share with others?

Arkansas: The majority of accounts closed by payment were smaller (under \$150) accounts. We were able to close a moderate number of accounts by locating taxayers for whom we had an estimated assessment.

California BOE: A significant amount of staff time was used for providing documentation to support the liability to the private collection company.

NY: The major negative factor we found was the extent of staff time and effort to support

the outside firms' collection actions.

EXHIBIT B

The State of New Jersey, Division of Taxation entered into two contracts with PAYCO General American Credits, Inc. for the purposes of collecting delinquent and deficient taxes.

The goal of each contract is to increase collection of revenue due to the State through the specialized use of trained telephone collectors.

Since the inception of the deficiency contract in February 1993, PAYCO has collected \$51,529,476 in known deficiencies. PAYCO has been paid \$11,328,543 for an overall revenue to expense ratio of 4.5:1.

Deficiency contract collections by fiscal year and associated statistics are as follows:

FISCAL YEAR	COLLECTIONS	EXPENSE	RATIO
'93	\$ 2,102,059	\$ 870,671	2.4:1
'94	12,175,480	2,841,557	4.3 : 1
'95	21,847481	4,287,458	5.1 : 1
'96	15,404,456	3,328,857	4.6 : 1

The delinquency contract, which targets known delinquent taxpayers, started in October 1995 and has collected a total of \$1,380,121. PAYCO has been paid \$349,181 on this contract for a 3.9: 1 revenue to expense ratio.

Both of these contracts have proven to be a cost effective way to increase revenue collections while reducing the Divisions workloads. Also, by taking advantage of outsourcing, the Division is able to reallocate permanent staff in other areas within the Compliance Activity.

EXHIBIT A

Although comparisons have been made between the private collector and the in-house employee, a complete analysis would be inconclusive. Our original mission for the private vendor was twofold - to help reduce our backlog of unanswered correspondence; and attempt to collect low liability accounts. The private collector was assigned accounts with liabilities of \$200.00 to \$10,000.00 and our employees worked accounts over \$10,000.00. That original mission has since changed. The private collector will be the Division's first attempt to collect a debt after the taxpayer has been notified of a deficiency and any rights to appeal have expired.

However we can appreciate their cost effectiveness in other quantitative ways. For instance, 1995 the private vendor collected 42% of the total liability assigned for collection. In addition to collections, a total of 65% of the cases assigned were closed through collections, adjustments, or account correction.

TO: Harley Duncan

FROM: Ken Rudio

Department of Administration

State Debt Collection

DATE:

RE: FTA Survey on Private Collection Agencies

The Department of Revenue of the State of Montana referred this survey to my collection section to complete.

I have enclosed a copy of the services we offer all State agencies, the IRS, and the county governments. It may help to explain some of my answers. It also provides you with some of the statistics we have with private collection agencies.

The collectibility of the debts referred to private collection agencies is only about 5% (five percent). The private collection agencies have 5 (five) million dollars of our debts referred to them. We basically use private collection agencies as a last resort effort and to pursue the accounts that will be expensive to collect. This is the reason for their high cost and low rate of return.

In 1995 private collection agencies charged us \$97,000 to collect \$270,000. Our internal collection program charged the agencies using our service \$44,000 to collect \$593,000. Prior to 1990, we used private collection agencies almost exclusively. What we learned was that we were paying collection fee's to the private collection agencies on debts we could collect ourselves.

DEPARTMENT OF ADMINISTRATION ACCOUNTING AND MANAGEMENT SUPPORT DIVISION

MARC RACICOT, GOVERNOR

MITCHELL BUILDING

- STATE OF MONTAN

Accounting Bureau Rm : 255 (406) 444-3092 Management Support Burea Rm. 176 (406) 444-4644 Helena, Montana 59620-0102

Department of Administration Debt Collection Services Mitchell Building

The Bad Debt Collection Services within the Department of Administration provides three specific categories of service regarding bad debts. These categories are as follows:

- A collection service for receivables transferred from state agencies which provides location, asset verification suit, garnishment and payroll withholding, and offset of state warrants to recover state receivables. This includes referral to private collection agencies.
- A tax offset only and locate service that allows state agencies to intercept state warrants and information without physically transferring the debt to this office.
- A "write-off service" for state agencies for debts totally uncollectible and debts that have been through the full collection effort performed by the Debt Collection Division.

The 1991 Legislature gave the Bad Debt Collections Division of the State Auditor's Office the authority to charge state agencies a collection fee for debts transferred to it for collection. The collection fee charged is based on the appropriation authorized and the collections generated from debts collected by the Division through conventional methods and tax offsets. No collection fee is charged for collection made by state debts referred to private collection agencies as they have already charged a collection fee.

Any excess fees collected above the authorized appropriations are carried over into the next fiscal year to reduce the percent charged the agencies; i.e., FY 92 authorized appropriation \$150,000 - projected collection \$882,352 requires 17 percent collection charge - Division collects \$1,000,000 in FY 92 means \$170,000 in commissions; therefore, \$20,000 is carried over into FY 93 budget \$150,000 - projected collections \$1,000,000. Since we carried over \$20,000, we need to generate \$130,000 in

commissions. That means we charge a collection fee of 13 percent for FY 93.

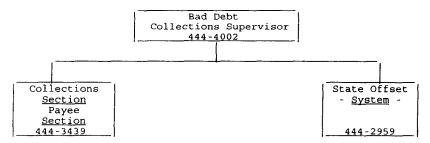
We proposed this idea to the legislature because the old method didn't fairly distribute the cost of collection. Fifty percent of our collections were from debts that didn't come from the state general fund. One hundred percent of the Division was funded from the general fund. Also, many agencies had the legal authority to add on collection charges, thus it didn't result in any revenues being lost.

Our major objective is to get the collection fee charged the agencies down to the lowest cost possible and still provide a total collection effort for all state agencies which includes a statutory write-off service for all state agencies. We want to request that when a state agency certifies and transfers a debt to our office for collection, they cease all collection activities on the account. All questions on the account of the debtor should be referred to the Debt Collections Division. Any questions we have will be obtained from the agency transferring the debt to us. The general rule for charging a collection fee is that the Debt Collections Division must be able to show it performed a collection effort on the debt. If an agency still maintains an internal means to collect a debt transferred to us, we won't charge a fee under reasonable circumstances:

- i.e., income tax debt where amended return filed; i.e., college loan where transcripts are held until loan
- paid; i.e., workers' compensation initial deposit applied to premium when payroll received on an estimated premium.

The circumstance can arise that a debtor whom we are holding an offset on will pay off a debt to avoid our collection charges. Our position will be to hold out the collection fee on the amount we are offsetting. The major objective is to collect the debt. We will be reasonable in determining if a collection fee should be charged. It has been our experience that cancelling and returning referred accounts from collection agencies causes the agency performing the collection service to pursue the account less aggressively if the debt is subject to return. These are just some basic guidelines to use to make the collection service more effective and avoid problems.

The Division flow chart is as follows:



Management memo 2-1100 explains the process of transferring a debt to the Bad Debt Collections Division for collection. It contains examples of the forms and explains the procedures for completing them. We developed another method of transferring debts for full collection electronically. This method allows the agency to obtain from Bad Debt Collections Division a format to keypunch all the information contained in the Bad Debt Certification and Transfer Form and transfer it to the Bad Debt Collections Division through a shared data set on the mainframe computer of the Department of Administration. The Bad Debt Collections Division will produce a Bad Debt Certification and Transfer Form which it will return to the agency for its signature. This eliminates the ordering of the Bad Debt Certification and Transfer Form. The Bad Debt Collections Division does not have to punch each debt into the computer as they will be electronically entered. We urge all agencies to use this method. Please contact the Bad Debt Collections Division and we will be glad to assist you.

Contact the Department of Administration, Collections Division, P.O. Box 200102, Sam Mitchell Building for further explanation of the services offered by the Division.

KR/kd

FY1995 Report of Collections, Debts Referred, Written Off and Computation of Collection Charges for 1996

REVENUE COLLECTED	FY95	FY94	FY93	FY92
Internal Collections	549,353	711,400	521,987	493,686
Tax Offsets	1,258,673	1,366,267	896,697	612,019
Private Collection Agencies	271,519	247,651	131,308	171,392
(Less Commissions)	(97,474)	(90,627)	(48,897)	(50,525)
TOTAL COLLECTIONS:	\$1,982,071	\$2,234,691	\$1,500,095	\$1,226,572
DEBTS REFERRED FOR COLLECTION	\$9,183,557	6,526,492	5,637,092	5,850,002
DEBTS WRITTEN OFF	\$5,386,933	9,185,152	1,982,218	161,179

COMPUTATION OF COLLECTION CHARGES

Revenue	Generated	to	Operate
State	Collection	on I	Program:

State Collection Flogram:	
Internal Collections:	\$ 549,353
Tax Offset:	1,258,673
Total:	\$1,808,026
This generated in REVENUE:	\$ 135,602
Carry Over from FY94:	56,029
Total Revenue FY95:	191,631
Total Expenses FY95:	(191,631)
Carry Over to FY96 Budget:	\$ -0-
uthorized appropriation FY96:	\$ 204,240
mount carried over from FY95:	-0-
FY96 BUDGET:	\$ 204,240
PROJECTED COLLECTION FY96:	\$1.685.226

PROJECTED COLLECTION	FX96:	\$1,685,226
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Assume we will collect same amount in FY95:	\$1,808,026
Less I.R.S. Collections:	(490,000)
Add Special Refund:	367,200
Projected FY96 collections:	\$1,685,226

Comparing Budget to Projected
Collections = % to charge agencies: \$\frac{204,240}{1,685,226} = 12\% = FY96 Fee Charged

In FY96 we will charge agencies 12%

HIGHLIGHTS: FY95

- In 1992 we proposed to fund the State Debt private Collection Bureau exactly like industry. The fee charged the state agencies using our services comes directly from the debt owed the agency. We gave our general fund appropriation back to the general fund. We have collected \$6,944,429 in the 4 years we have been self funded. It cost the agencies using our services \$778,827. During the 17 years the program was funded by general fund, we collected \$5,540,343 with a cost of \$899,362 to general fund. Under the selffunding program, we are returning 1.73 million dollars per year to the taxpayer. general fund funding, we were returning \$272,999 per year to the taxpayer.
- We were referred \$9,183,557 in debts from 30 state agencies. This is the largest number of debts every referred to the State Debt Collections Bureau. I feel this was due to the great rate of return the state agencies were getting for our services. 7.5% translates into a thirteen (13) dollar return for every dollar spent.
- 3. The legislation to help counties collect delinquent personal property tax passed. I estimated that there is from 11 to 20 million

in delinquent personal property taxes. When collection procedures are fully implemented we should recover 1/2 million dollars annually for the counties. New sources of revenue are what keeps our rates at such a low percentage and encourages agencies to use our services.





FRANCHISE TAX BOARD P.O. BOX 1468 SACRAMENTO CA 95812-1468 (916) 845-4166

April 11, 1996

Mr. Harley T. Duncan Executive Director Federation of Tax Administrators 444 North Capitol Street NW Washington, DC 20001

Dear Mr. Duncan

Attached is your completed questionnaire concerning California's experience with the collection of delinquent income taxes utilizing the services of private collection agencies. We hope that this information is useful to you. The following additional information is provided to enhance your perspective in consideration of our responses.

California's in-house collection activities are centered on automated systems that identify delinquent accounts, initiate requests for payments, match accounts with employment and asset ownership data and, as needed, initiate liens or levies. Accounts not fully resolved by these automated systems are candidates for possible supplemental processing by either our own staff and/or private collection agency.

In general, accounts worked by our staff are those expected to yield the highest returns. This is achieved by modeling the accounts in accordance with historical revenue return rates and by staffing at levels sufficient for our staff to work all models expected to generate an overall return rate of \$5 revenue per \$1 cost. Only accounts not meeting this overall criteria are available for referral to our private collection agents.

In regard to question No. 15 and the relative cost of contracting with agents in comparison with the cost of in-house personnel, such compansons are particularly difficult because the kinds of work to be done are different. The agent's actions are limited to locating debtors and obtaining payments of debts not disputed. Any disputes as to the amount or validity of the debt are necessarily referred back for resolution. In respect to agency referrels, this has the effect of saving us the cost of attempting to seek out debtors that cannot be located but increasing the cost of resolving accounts of debtors who are located, since the latter will require both account resolution activity by our staff as well as payment to the private agent out of the debt proceeds.

If you or your staff have any questions or would like any additional information, please do not hesitate to call me at (916) 845-4166.

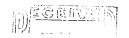
Sincerely,

Tom Rogers

Manager, Collection Program Administration

cc: G. Goldberg

J. Vranna



Additional Detail - Ohio



DEPARTMENT OF TAXATION

Harley T. Duncan Executive Director Federation of Tax Administrators 444 North Capital St., N.W. Washington, D.C. 20001

Dear Mr. Duncan:

The Federation of Tax Administrator's survey has been referred to me for response.

Your survey would be better addressed by Mr. William Hopper of the Attorney General's Office. I have, therefore, requested he assist in the completion of this survey.

The collection process in Ohio involves the Attorney General's Office as well as the Tax Department. The actual collection activities and/or legal actions are the responsibility of the Attorney General's Office.

In Ohio, the Tax Department's role in collection is to bill, assess (legal collection notification) and refer accounts remaining unpaid after a specified time period to the Attorney General for collection. The department remains involved throughout the entire process in that various information is referred after certification which may require adjustment of liability or response to the taxpayer on technical tax matters.

The Attorney General's Office is the owner of the Ohio Automated Collection System. The Automated Collection system handles the assignment of cases. How assignment for collections are made, types of outside collection activities performed by collection agencies, assignment of accounts, revenue collected, payment of fees to agencies, etc., is information which the Attorney General's Office would maintain.

The second state of the se

P.O. Box 1090 Columbus, Ohio 43266-0090 The Automated Collection System supports the major taxes in Ohio (i.e., Individual Income, Employer Withholding, Corporate and Sales). Sales liabilities enter the system at the point of assessment. Personal income, Withholding and Corporate enter the system at the point of certification.

Our contact with the "outside" collection agencies retained by the Attorney General's Office has been very positive.

If I can be of future service, please let me know.

Cordially,

Darbus a Huthelf
Barbara A. Mitchell
Administrator
Assessment Division

BAM/rm

cc: William Hopper

WHEN WE STARTED OUTSIDE AGENCY COLLECTIONS.

In 1981, we entered into our first contract with an Outside Agency for collections of the Divisions' receivables. The early years can be described as having varying degrees of success. Our first endeavor dealt with the placement of Non-Resident Taxpayers Personal Income Tax delinquency, then over the years it was expanded to include Resident Taxpayers. During the mid 80's a large number of accounts dealt with unable to locate. While the end of the 80's saw us expanding the program to include the total mix of delinquency for Personal Income Tax of Resident, Non-Resident, Unable to Locate, and for the first time the placement of these account directly after the completion of the billing process. It should be noted that all placements at this time would have had a judgment place against the taxpayer(s).

In the 90's, the Division revamps its information systems and we move from a multiple receivable system to a single integrated system; from a decentralized accounting and control to a centralized accounting and control; from a paper based system to an image system. With these information systems in place, we can now manage and control receivables. We expanded our Outside Agency Collection (OCA) Program to include all taxes administered by the Division, as well as, the number of collection agencies from one (national firm) to three (two national and one local firm). They now received two types of cases.

One, all delinquencies directly after billing between a dollar range set by the division; additionally, no judgments have been place against the taxpayer. We have found that over the course of years, that if you can make contact with the taxpayer very early in the enforcement program process that not placing the judgment yielded a higher collections. When a case is returned from the OCA it will be examined to a set of criteria and a judgment filed when it meets the conditions set forth in our rule processor.

Two, accounts that the Bureau of Tax Collections recommends; they may or may not have judgments in place.

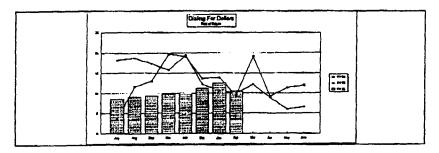
it should be noted that since the beginning of our OCA Program, we have had the ability to have the agency litigate the case on behalf of the Division for out of state cases. The Division has only recently began to exercise this means of enforcing problem accounts in which all other efforts have failed.

We experienced a 101% increase in dollars collected when comparing FY '94 to FY '95, which was the first full fiscal year of operations, having expanded our OCA Program from one to three participants.

WHEN WE STARTED WITH DIALING FOR DOLLARS

In May of 1993, we engaged an outside collection firm to provide for collection personnel on site at the Division for aiding us in the collection of Personal Income Tax accounts. June of 1994, we increased the number of collectors to 4 and formulate a team. The team consisted of a Tax Examiner (Problem Resolution Person) to assist the 4 on site collectors with problem accounts. All issues with regard to computation of tax, penalty, and interest are handle by the four collectors. Issues concerning compound and complex tax issues are then forward to the PRP, who in turn will review and respond to the taxpayer's inquiry. January 1995, we expand by adding two more collectors and including the Business Taxes into our Dialing For Dollars Program. We are currently re-evaluating the mix of collectors to PRP's with anticipation of a new Business Tax Gross Receipts System brought on-line September 1995 and a anticipated a new Corporate Reconciliation System sometime in the first quarter of 1996.

Below is a chart showing the rate of return for utilizing the rent a collector to Problem Resolution Person team. The ratio followed our traditional Personal Income Tax filing activity of April through December. We anticipate some change, as we go forward with the installation of new Business Tax Reconciliation Systems, but we will still see peaks for the Personal Income Tax activity.



The Dialing For Dollars program has shown a program average ratio of 11.78 to 1. We feel this return rate will remain in excess of 6 to 1 even as we bring on the new Business Tax Reconciliation Systems.

WHEN WE STARTED SECONDS

RFP's specifications for the placement of second referrals of delinquent cases were sent to 36 firms in the month of September 1995. The closing date is September 28, 1995, and the anticipated contract negotiation are expected to take approximately 30 days. We look forward to a installation date of November 1, 1995. At this time, we are uncertain as to the rate of recovery, but inlight that we will only pay for recovered dollars, all dollars collected is monies the Division would not have seen.

WHAT THE DIVISION GAINED.

The Division has made great strides to increase the collection program performance, as you can see by the increase of 101% in dollars collected via the OCA and the 11.78 ratio of return for the Dialing for Dollars programs. Another benefit to the Division is, the Bureau of Tax Collection permanent staff has been reduced by 20% with the recently installed Dialing for Dollars program. The professional staff that had been assigned to Bureau has now been reassigned to the Bureaus dealing with the Examine/Audit activities within the Division.

THE FUTURE.

The Bureau of Tax Collection will continue to reassess the performance of its programs of OCA and Dialing for Dollars and like opportunities to further reduce the cost of enforcement collections; thereby, saving taxpayer expense.

ADDENDUM TO FTA SURVEY ON PRIVATE COLLECTION ACTIVITIES

The Texas State Comptroller's Office does not currently utilize private collection agencies to collect delinquent taxes. However, since May of 1994, we have maintained a contract with a private temporary employment service that supplies us with contract personnel to staff our Automated Collections Center (ACC). Under the contract, we employ approximately 40 individuals who, under direct supervision of agency personnel, make outgoing collection calls on primarily delinquent sales tax accounts.

These phone "agents" have limited access to account information, and use prepared scripts when making their calls. Their main responsibilities are to make phone contact with delinquent taxpayers, establish/estimate liability, obtain a commitment to pay, and/or update limited account information if necessary. If the phone collection approach is unsuccessful and the established liability becomes final, the accounts are sent to the field for contact by agency collection personnel.

This process has proven highly effective in reducing the backlog of sales tax accounts, and allowing our field personnel to concentrate on priority accounts (high dollar). In the first full year of operation (FY95) under this new concept, collections for the ACC increased 17%. The biggest reason for this increase was the change in procedure from an in-depth account analysis by experienced agency personnel, to a "quick hit", "dialing for dollars" approach requiring limited account research. The result was a decrease in time per call, increased taxpayer contacts, and increased collections. It is interesting to note that though collections per direct phone hour decreased by 10%, the increase in taxpayer "hits" combined with the decrease in overhead resulting from the use of contract personnel actually increased the ACC's rate of return by 23%.

Though using contract personnel to assist in our collection process has proven fiscally responsible, it has also had its share of problems. The most obvious shortcoming is the lack of expertise to handle taxpayer questions, resulting in an additional burden on our field personnel. To reduce this burden, we have recently re-hired a small group of specialists to take incoming collection calls referred by our contract personnel. A second problem is the transient nature of temporary service personnel. Since it takes several days to train and get agents accustomed to making collection calls, the constant turnover limits the ACC's potential productive capacity. And finally, for both of the aforementioned reasons, we have had to limit the scope of collection activity of these contract agents to our two major taxes, sales and franchise. This has resulted in a backlog of smaller, low priority taxes that are rarely worked by our field personnel.

In summary, we have been very pleased with the effectiveness of this new program. Delinquent collections continue to increase as we adjust our processes to best utilize the contract staff. One of our goals for the coming year is to determine an optimum staffing level based on workload and productivity factors. Though we realize the inherent problems associated with a transient workforce will remain with us, we expect the program's pros will continue to outweigh its cons.

Chairman JOHNSON. Thank you very much.

I would like to ask the panel if you have had any problem in using private debt collectors in the privacy area, in the appeals area. Have you had any problems of the kind that we are being cautioned to avoid?

Mr. GOLDBERG. The one problem we did have in California, initially, was one wherein we did not take proper consideration of the financial viability of vendors. So consequently one of our vendors went bankrupt. While none of the moneys were at risk, we had some difficulty, initially, getting some of the accounts back from the bankrupt vendor.

Beyond that, we did have some initial complaints, but I think those were more a matter of training than the collection agencies not wishing to actually participate properly, and once we provided

that training, those problems appear to have gone away.

Chairman JOHNSON. So have you had no problem of commingling of tax and nontax data? Those privacy issues that people are worried about?

Mr. GOLDBERG. We have not had any significant problems in that

Mr. GAVIN. In Connecticut, under our State laws, the only information that is provided to outside collectors is that which is already public information, available to the public. What do I mean by that?

In Connecticut, under our statutes, if a tax debt exists after all appeal rights have been exhausted, 90 days after that, that person's name, the tax type, and the amount, is public information, and the address.

Not the Social Security number. So when we outsource to private collectors, the only information they are getting is public information—name, address, amount of tax, and the type of tax.

Based on our experience—and we have been doing it for 2 years now—the number of complaints, there have been some complaints but no different than the amount of complaints we normally receive as a tax agency ourselves.

So we have been very pleased with the results, so far, and have in fact now increased the amount of use of outside private collec-

tors to 10 percent of the number of our accounts.

If any customer service-related issues come up, it is their instructions, the outside collection agency, to refer them to us and we handle that.

Chairman JOHNSON. And one last question. In your experience with the amnesty program, have any of you had long enough experience to feel confident it does not provide an incentive for people not to pay their taxes, assuming there will be yet another amnesty program?

Mr. GAVIN. Connecticut was the first State to have two fullblown tax amnesties. We had one in 1990 and in 1995. Now, the reason we had one in 1995 was that in 1990, when we had our

original, we did not have a personal income tax.

Connecticut is still in its infancy stages, really, with the personal income tax, and based on our studies of the 35 States that have had tax amnesties, those that had personal income tax, the number one applications came in from individual income tax filers.

That held true in 1995, and that is the reason why we could perform a second tax amnesty. I believe that a tax amnesty should be considered a one-time opportunity unless unique circumstances require or suggest that a second one should be performed in Connecticut.

I can say to you that the Governor and the General Assembly approved that, thought that that was the case, and based on our analysis, since the bulk of the money did come from personal income tax filers—and let me just tell you this, which is also an interesting fact when we talk about accounts receivable.

In our experience in both programs, approximately 52 percent came from people who were on our accounts receivable file, and the remaining 48 percent were new filers, or underreporters. You have to remember that another great benefit of a tax amnesty program is not only are you going to get an influx of money in the year of the amnesty, but with some good marketing and advertising, and following up with strong enforcement tools after an amnesty, you are going to have those new filers on the tax roles forever and get a new stream of income, and that reduces the burden for everyone.

Chairman JOHNSON. Thank you.

Mr. Matsui.

Mr. MATSUI. Very briefly.

Mr. Duncan, you seem to have answered Mr. Ensign's concern. He testified. As you know, you were in the audience. Are you from Washington or are you outside of Washington?

Mr. DUNCAN. No. We are based here.

Mr. Matsui. I would recommend that you perhaps—and maybe you have already done this—visit Mr. Ensign and discuss this with him because obviously, if we do anything on the offset—and I believe we may—it certainly would be helpful, perhaps if you met with him, and chatted with him.

I think the issue that there would be a judgment might alleviate some of the concerns, which you have stated in your comments, in your testimony. So I would just make that recommendation, and maybe you have already made a note of that.

Mr. GOLDBERG. Mr. Matsui.

Mr. MATSUI. Yes, Mr. Goldberg.

Mr. GOLDBERG. I might just also point out with regard to Representative Ensign's comments, he indicated that roughly 44 percent of the offset amount would be from nonresidents. Our calculations at the Franchise Tax Board would indicate that the amount would be less than 4 percent as opposed to 44 percent.

Mr. Matsul. I see. Are they all in Nevada? [Laughter.]

Gambling debts, huh?

I want to thank all four of the panelists. I appreciated this. Obviously, we are going to be looking to your expertise over the next few months, or years.

Thank you.

Chairman JOHNSON. Thank you much for your input.

Would you like to question, Mr. Cardin?

Mr. CARDIN. No questions, Madam Chairman.

Chairman JOHNSON. Thank you.

I thank the panel and would call forward the last panel, Joseph Lane of the National Association of Enrolled Agents; Curtis Prins, a legislative consultant, American Collectors Association; and Saul Moskowitz, a partner in Dean Blakey and Moskowitz.

I would ask that Mr. Lane proceed.

Mr. MATSUI [presiding]. I want to thank all three of the gentlemen.

Chairman Johnson had to take a phone call that came in. She needs to take this now, and so I am going to call Mr. Lane to start. Mr. Lane.

STATEMENT OF JOSEPH F. LANE, ENROLLED AGENT, NATIONAL ASSOCIATION OF ENROLLED AGENTS

Mr. Lane. Thank you. We appreciate the opportunity to appear again before the Subcommittee and give our opinions about this proposal.

Before I start my comments, and Mr. Chairman, we have written comments we have submitted for the Subcommittee. We would hope you would just accept, and I will summarize.

Mr. MATSUI. They will be so entered in the record.

Mr. LANE. Thank you.

NAEA, the National Association of Enrolled Agents, strongly supports the concept of IRS studying ways to improve its service to taxpayers and achieve efficiencies in the management of the public revenues entrusted to it. In addition, we want to point out that over 90 percent of our members own and operate their own tax representation practices.

So, we certainly are supportive of small business entrepreneurship. Having said that, I advise the Subcommittee we are absolutely opposed to the concept of outside collection agencies getting involved in the collection of Federal taxes.

The confidentiality of tax return data is of paramount importance to our voluntary compliance system. At one time in America, we could say the same about most of our financial dealings, but unfortunately, that is no longer true.

The confidentiality of income tax return data is the last remain-

ing bulwark, and we believe it should be retained.

We have been before the Subcommittee several times in the last year, and we have, at various times during that testimony, pointed out problems we had with individual specific employees of the Internal Revenue Service or some of the policies they may have enacted, that we disagreed with.

But we want to recognize the overwhelming majority of IRS employees that are dedicated, ethical individuals interested in performing their difficult jobs within the guidelines set out by the Service and the Congress.

The IRS does extensive background investigations to help elimi-

nate potential problem employees before they are selected.

Once on the job, they have very strict rules of conduct which employees are expected to adhere to, and there is an established disciplinary process in place to deal with employees who violate those rules

In sharp contrast to the relatively high caliber of IRS recruits and the tightly regulated systems within the Service to protect tax-payer data, we have been appalled at the "horror stories" in exposes we have read about the commercial collection industry.

This industry has such low hiring standards and such shoddy and unethical practices, that Congress itself has been forced to regulate it many times over the last three decades.

We would urge that if this pilot program does go forward, that the IRS be required to look at the Federal Trade Commission

records on the companies that are bidding on this contract.

If you call some people from the Federal Trade Commission before this Subcommittee, I think you will find out that many of these firms have been cited for violations of their business practices and fined significant amounts.

Those types of firms should not be allowed to participate in the

IRS test, if it goes forward.

In preparation for our comments today, we did an E-mail poll of our members and asked them for comments concerning their dealings with the private collection agencies utilized by the State and municipal taxing authorities around the country. We have not received a single positive comment. Our members have related tales of taxpayers being threatened with legal actions not permitted under law; with threats of additional penalties not authorized by the taxing authorities; with demands for delinquent taxes without any explanation about the cause for assessment; with demands for taxes that had expired statutes for collection; with demands for excessive financial information disclosure; with demands that taxpayers file delinquent tax returns, not with the State agency but with the collection agency; and finally, for demands for taxes already discharged in bankruptcy proceedings.

One member alerted us to the fact that the city of Philadelphia has contracted with a 250-person firm, and the name of that firm is the Municipal Tax Bureau. If ever was a name intentionally de-

signed to confuse taxpayers, that is it.

We are concerned about the production quota environment. The IRS has long realized that in a production quota environment, the first casualty is taxpayer rights. I was a collection division chief in the IRS when we first implemented the restrictions for keeping enforcement statistics on individual employees, and I can vouch for the impact this had throughout the whole organization.

Gone immediately were the last week of the month seizures of taxpayer assets just because someone was behind on a chart hang-

ing in the group area.

Gone immediately were local district policies of seizing any business taxpayer with delinquent payroll taxes within 24 hours of receiving the case, and that was the case, gentlemen.

I have on a wall in my office, an award I received as a revenue officer in the collection division, for making the most seizures in

my group that month.

In contrast to that environment, one of the collection agencies around the country located in Texas, as I understand it, has a leather bomber jacket in a glass case in their lobby, and it gets awarded every month to the collection "ACE" that shoots down the most money.

Is this really what we want to be broadcasting to taxpayers? Do we really want to restrict government employees who must meet strict hiring qualifications and are fully accountable to a defined chain of command regarding their actions, while leaving unfettered

commercial firms who can dragoon anybody off the street, regardless of qualifications, and give them this confidential material to work with? We think not.

We are very concerned about the way the proposal has been written by IRS, and the bonus payments on full pay cases. I do not know if you have had a chance to review the RFP, in detail, but there is a multiple paid to the contractor that gets a full paid case.

Mr. MATSUI. Mr. Lane, could you try to wrap up your testimony. I do not want to interrupt any one of the three of you, but we are trying to limit everyone to 5 minutes, and this room will have to be used later, by someone else, and so we are trying to move ahead.

Mr. LANE. That is fine.

Mr. MATSUI. If you will proceed, and if you can conclude.

Mr. Lane. We are concerned about the bonus paid, and we have certain suggestions we have submitted to the Subcommittee. There are a total of five suggestions, which spell out how we think the IRS could utilize outside resources by contracting, but not involve the potential violation of taxpayers' rights. We spell those out, in

detail, for the Subcommittee in our written report.

We also are in favor of, in general, most of the items covered in the proposed 6402 changes with the exception that we would not want to see non-means-tested Social Security payments subject to an automatic levy. There are just too many elderly people in this country that have the potential to have too many errors made, that wind up having 15 percent of their Social Security check withheld, and they do not have the resources to pay professionals to go out and get these levies released and get their money back.

So, I will be happy to take any questions.

[The prepared statement follows:]

STATEMENT OF JOSEPH F. LANE ENROLLED AGENT ON BEHALF OF NATIONAL ASSOCIATION OF ENROLLED AGENTS

Madam Chair, Members of the Subcommittee, my name is Joseph F. Lane. I am an Enrolled Agent in private practice in Menlo Park, California. 1 thank you for your invitation to testify on behalf of the National Association of Enrolled Agents regarding the proposal to permit the IRS to contract out some of its Collection work to outside collection agencies and the proposal to expand levy authority under the Internal Revenue Code.

I am testifying today on behalf of the more than 9,100 members of the National Association of Enrolled Agents (NAEA). As the members of the Subcommittee well know, Enrolled Agents are the only tax professionals possessing a Federal license to represent taxpayers before the Internal Revenue Service and our members represent more than four million (4,000,000) individual and small business taxpayers annually. NAEA is especially appreciative of the interest this Subcommittee has taken in the matter of Internal Revenue Service practices and procedures and their impact on taxpayers. We pledge our support to further assist the Subcommittee in the future on issues which effect the general taxpaying public.

NAEA is Opposed to the Outside Collection Agency Test

Before I begin my remarks, I want to make the point that the NAEA strongly supports the concept of the IRS studying ways to improve its service to taxpayers and achieve efficiencies in its management of the public revenues entrusted to it. In addition, it should be pointed out that since over 90% of our members own and operate their own tax representation practices, that the NAEA is certainly supportive of small business entrepreneurship. Having said that, I must advise the Committee that we are fervently opposed to the proposed outside collection agency test.

History of Tax Return Confidentiality

Up until recently, there has been a sacred agreement between the taxpayers who file their returns and the government. The confidentiality of tax return data is of paramount importance to our voluntary compliance system. At one time in America, the same could be said of most of our financial dealings. Unfortunately, with the wide-spread expansion of credit availability and the enhancements to computerized technology, there has been a devolution in the confidentiality of much of our previously privileged financial lives. The confidentiality of income tax return data is the last bulwark remaining. It should be retained.

Reliability of Internal Revenue Service Employees

While we have, in past hearings, complained to the committee about specific actions taken by some Service employees or specific policies with which we disagreed, NAEA recognizes that the overwhelming majority of IRS employees are dedicated, ethical individuals interested in performing their difficult jobs within the guidelines set forth by the Service and the Congress. The Service has always set high standards of qualification for employment in its field positions and, we believe, does an excellent job in vetting the applicants it considers. The background investigations it performs help to eliminate many potential problem employees and weed out those who would attempt to abuse the power entrusted to them in their official capacities. Once on board, the Service clearly delineates through its Rules of Conduct and on the job training regimen exactly what expectations it has of its employees. There is an established disciplinary process in place, and often used, to insure that all employees meet the high expectations set out for them.

Even given all of these safeguards, we have seen press reports in recent years where hundreds of Service employees have had to be disciplined because they were "browsing" confidential taxpayer data they had no right to look at. The reason these violations were discovered is because the Service has stringent controls over who may access certain computer files and has programmed tracking devices into the software to identify those who attempt to access information not already assigned to them.

The Commercial Collection Industry

In sharp contrast to the relatively high caliber of IRS recruits and the tightly regulated systems within the Service to protect taxpayer data, we have all been appalled at the "horror" stories and exposes we have read concerning the commercial collection industry. This industry has such low hiring standards for employees and a reputation for such shoddy and unethical business practices that Congress has passed legislation over the past three decades to rein in its abusive methods. It is inconceivable to us that any serious thought is being given to turning over confidential tax data to an industry with the track record "enjoyed" by the commercial collection industry. We would urge the Committee to ask the Federal Trade Commission about the reliability and ethical conduct of many of these commercial collection agencies. At the very least, the FTC records ought to be considered by the Service in evaluating the companies bidding on the current proposal.

Our Members' Comments

In preparation for today's hearing, we polled our members via e-mail and received many comments back concerning their experiences dealing with commercial collection agencies currently used by state and municipal taxing authorities around the country. We have not received a single positive comment. Our members have related tales of taxpayers being threatened with legal actions not permitted under law; with threats of additional penalties not authorized by the taxing authorities; with demands for delinquent taxes without any explanation about the cause of the assessment; with demands for taxes with expired statutes for collection; with demands for extensive financial information disclosures; with demands that taxpayers file delinquent tax returns, not with the state agency but, with the collection agency, and finally for demands for taxes already discharged in bankruptcy proceedings.

In almost every instance, our members have cited the lack of professionalism of the collection agency personnel compared to the state revenue department employees. One member reported that revenue department employees are "more knowledgeable, friendlier and LESS bureaucratic" than those working for collection agencies. Many commented on the lack of knowledge of the people they spoke with, the single concentration on collecting the amount due regardless of the accuracy of the assessment and no awareness of how to resolve cases where the accuracy was at issue. One member related how the City of Philadelphia has contracted with a 250 employee firm which calls itself the Municipal Tax Bureau (clearly a name chosen to mislead taxpayers) thereby permitting this independent enterprise to get direct access to Federal records and bypass the State of Pennsylvania tax department. This has to raise serious questions as to how this group uses the information they get and how secure their systems are. Who regulates these hired guns?

Production Ouotas

A major concern of NAEA members is the negative impact on taxpayers derived from turning over their cases to an industry noted for its heavy emphasis on production quotas. The IRS long ago realized that in a production quota environment the first casualty is the taxpayer's rights. It is precisely for this reason that the Service prohibits its managers from keeping enforcement statistics on individual employees. It rightfully recognizes that any evaluative system which permitted these statistics to be used would create a competitive atmosphere not conducive to protecting taxpayer rights. It is tough enough to work in the tax collection environment without adding "production quotas" to the mix.

I was a Collection Branch Chief when we implemented the restrictions on keeping enforcement statistics and I can vouch for the impact this had throughout the organization. Gone immediately were the last week of the month seizures of taxpayer assets just because someone was behind on the chart hanging in the group area. Gone immediately were local District policies of seizing any business taxpayer with delinquent payroll tax liabilities within 24 hours of receiving the case. Instead, enforcement actions were taken when warranted in the good judgment of the Revenue Officer assigned the case. Contrast this environment with that of the Texas company with a leather bomber jacket in the glass case in its lobby that gets awarded every month to the

Collection "ACE" who "shot down" the most money that month! Is this really what we want to be broadcasting to taxpayers? Do we really want to restrict government employees, who must meet strict hiring qualifications and are fully accountable to a defined chain of command regarding their actions while leaving unfettered commercial firms who dragoon anyone off the street to work on such confidential material. We think not!

IRS Solicitation 96-0014, Collection Related Activities

We have reviewed the IRS Request for Proposal issued on this topic and we are concerned about many aspects of the solicitation. The proposed procedure would assign cases to outside collection agencies only on taxpayers who did not have a Power of Attorney on file with the Service. In other words, the most vulnerable taxpayers would be the first to go. Those taxpayers who had the least knowledge of their rights would be cast to the commercial agencies.

We also are concerned about the methodology of bonus payments for full pay cases. While it is understandable from a business incentive perspective, it is precisely this mind-set we object to. The Service would never permit one of its group managers to award a Revenue Officer in the field more pay because a greater percentage of that employee's cases were closed with full payments as opposed to some other method of disposition. That would create a motivation to collect full pays regardless of the facts of the case and could easily lead to mishandling the case.

If the Service can see the wisdom of this restriction on its own valued, trusted and reliable employees how can it suggest that it not also be applied to those it has little, if any, control over?

NAEA Proposals for Privatization

We believe that there are several areas the Service could consider for privatization which would achieve the benefits of increased efficiency and cost reduction and not involve the risks to taxpayer rights and confidentiality we addressed above.

First, the increased number of bankruptcy filings has created a much higher inventory of such cases. The Service could contract out the task of representing the Government in the bankruptcy forum. This would provide for the retention of specialists in a narrow field of expertise, affect very few taxpayers, insure taxpayer rights since most of the taxpayers involved would be represented by counsel or trustees, and perhaps insure a greater monetary return to the Service than it currently secures.

Second, the Service recently implemented National and Local standards for purposes of making Collection case decisions. This process could now be automated by permitting practitioners to electronically submit completed payment arrangements directly into the Service's computers. The Service already has the power under Circular 230 to regulate the practice of Enrolled Agents, CPAs and attorneys who represent taxpayers. We can easily see the efficacy of an automated system which permitted the practitioner to process everything needed for the installment payment arrangements directly into the IRS system without involving any IRS employee.

Third, the Service should consider entering into joint Federal-State agreements to permit State Departments of Revenue to collect delinquent IRS accounts at the same time they are working the state accounts. In many instances, taxpayers owe both agencies at the same time and the effort to jointly resolve cases would accrue to everyone's advantage. We have been testing the feasibility of joint payment agreements between the IRS and the California Franchise Tax Board for delinquent taxes for just over a year now. The State of Minnesota established an entity called the Minnesota Collection Enterprise which provides collection services for 13 different State agencies collecting student loans, child support, OSHA fines, pollution fines, restitution claims and benefit overpayments in addition to taxes. Since many of these program have Federal funding approximately 50% of the total dollars collected are returned to the Federal government. We believe this option also ought to be explored by the Service.

Fourth, the Service should consider licensing the rights to sell tax information publications to practitioners and the general public. Given the recent increases in the price of paper and postage and in light of their current budget situation, the Service is currently considering discontinuing certain valuable taxpayer information publications. We believe these are valuable enough to most users that a reasonable fee could be charged to cover the production costs and this should be considered before discontinuing publication.

Fifth, the Service should consider contracting with a national payroll service firm to handle the withholding, depositing, filing and paying of the employment taxes owed by companies who have histories of non-compliance with their payroll tax responsibilities. We believe that significant cost savings could be realized by quicker follow-up on high risk repeater trust fund tax violators and feel that the commercial payroll services are better suited for this monitoring function than the Service's Collection Division.

Proposed IRC Section 6402 Changes

We are generally in support of the changes outlined in H.R. 757 and H.R. 2234, with one very major exception. We are opposed to the inclusion of Social Security benefit payments under the automated levy offset program. We agree, in principle, that the automated offset procedure be adopted for most non-means tested disbursements but are especially concerned for the elderly taxpayers who depend on their monthly Social Security benefit for the necessities of life. The current Internal Revenue Manual requires supervisory approval prior to levy upon Social Security benefits and we believe this is well considered and should be retained. There are too many instances where erroneous information is processed through the system and assessments are generated to risk that any elderly taxpayer be deprived of a major source of their retirement income and necessitate their seeking out professional help to secure a refund of an erroneous levy. Many of our senior citizens have remarked on how the complexities of financial life today overwhelm them. We see no need to add to their concerns about Social Security. The current system works fine, it is not broken and does not need to be fixed.

Summary

We thank the Committee for the opportunity to appear today and will be happy to respond to any questions the members may have about our remarks.

Mr. MATSUI. Thank you, Mr. Lane. Mr. Prins.

STATEMENT OF CURTIS A. PRINS, LEGISLATIVE CONSULTANT, AMERICAN COLLECTORS ASSOCIATION, MIDDLEBURG, VIRGINIA

Mr. PRINS. Mr. Matsui, Mr. Cardin, ACA, the American Collectors Association is a worldwide trade association of debt collection professionals with some 3,400 members in the United States.

Today, I would like to clear up some of the myths about the debt collection industry, particularly as they pertain to collection of debts for the Federal Government, including the Internal Revenue Service.

Currently, private collectors handle accounts for some 80 programs of the Federal Government, including the Department of Education, where they have collected some \$1 billion in delinquent student loans, including \$650 million in just the last 2 years alone.

We are also collecting taxes for 32 States, including your home State of Connecticut, Mr. Chairman, your home State of California, Mr. Matsui, and your home State of Maryland, Mr. Cardin.

Legislation currently before Congress would allow all Federal agencies to use private collectors and ACA strongly supports that initiative.

More than \$200 billion in delinquent taxes are owed the Internal Revenue Service and the General Accounting Office estimates that the figure increases by 8 percent each year.

Unless private collection agencies are used to collect IRS tax debt, a large portion of the \$200 billion will be lost forever. Everyone is concerned about taxes. How can we justify the loss of perhaps as much as \$200 billion in tax revenue, particularly at a time when the country faces severe budget cuts?

Why should people who pay their taxes have to subsidize those taxpayers, or perhaps we should call them tax delinquents, who are responsible for the \$200 billion in tax delinquencies?

How many new roads could be built with that money? How many child care facilities built, and perhaps even a cure for cancer or AIDS discovered with those funds that will be lost forever if we do not act?

Here is what ACA proposes to solve the problem. When an IRS tax delinquency reaches 180 days, it should be turned over to the Financial Management Service of the Treasury Department which has broad experience with private contractors, who will then turn the accounts over to private collection agencies.

This will free up the IRS to concentrate its efforts on the most collectible accounts, and relieve the agency of handling outside collection contracts.

Our plan will not result in the loss of any jobs at IRS, since most of the accounts that would be turned over to the private collection agencies are not actively being worked by IRS.

How will private collection agencies be able to collect on these accounts when the IRS has failed?

Private collection agencies have state-of-the-art technology, both hardware and software, and that equipment is updated constantly.

Our collectors undergo continuous training to improve their collection skills and we are able to increase our work force and equipment inventories without government budget constraints.

Contrast this with the IRS operation. The GAO has stated in testimony before the Appropriations Committee that the IRS is still

using fifties and sixties collection technology.

Let me turn to some of the major concerns that have been expressed about IRS using private collectors. Privacy is one of the first issues that should be addressed.

There have been unfounded fears that collectors will have access to tax records. That is not the case, nor is it the case when collectors work for State, local, or commercial concerns.

The collector will be given the name of the individual or company that owes taxes, and the amount, an address, phone number, if available, and place of employment, if known. That is it. We will not get, and do not want tax files or any unimportant personal information about the taxpayer.

If you are worried about privacy, consider the Department of Energy, which has not received a single privacy complaint involving a private collector in the 14 years that the agency has used private firms.

On the other hand, remember the 1,300 IRS employees who have been caught snooping into taxpayer records since 1989. Yes, there may be a privacy problem, but it is with IRS, not private collectors.

Payment for private collectors is also an area that must be addressed. Under current law, contingency fees are not allowed. That should be changed, so the collectors only get paid when they collect.

That is the way the system works for all other Federal Government agencies in the private sector, when using private contractors

Congress should not wait until the current IRS test program is completed before adopting changes in the IRS delinquent tax collection program. The test program is so flawed that many PCAs are not bidding on the contract, and those that are bidding are convinced that they will lose money, but hopefully will get in on the ground floor for later contracts.

It has been mentioned that this is a fair contract by people who are promoting it. I would suggest, Mr. Chairman, that the IRS test collection program is not as honest as professional wrestling.

Mr. Chairman, and Members of the Subcommittee, we cannot afford the loss of \$200 billion of tax revenue.

ACA has presented a plan that prevents such a loss. We urge you to adopt that plan and to do so quickly, so that additional tax dollars will not be lost.

In conclusion, let me make this offer to you and your staff.

There are many collection agencies within a few minutes' drive of the Capitol. I would be more than happy to entertain the Subcommittee to come out and see exactly how we work and to put to rest the myths that have sprung up during this hearing.

Thank you very much.

[The prepared statement follows:]

Testimony of Curtis A. Prins, Legislative Consultant
American Collectors Association
Before the Oversight Subcommittee
Ways And Means Committee
U. S. House of Representatives
April 25, 1996

Madam Chairwoman: ACA is a worldwide trade association of debt collection professionals with some 3,400 members in this country. We are the largest association of collection agencies, representing agencies from the mom and pop size to ones with 400 to 500 collectors.

The collection industry is one of the least understood but perhaps one of the most important businesses in our economy. Each year, our industry collects some \$18 billion that might otherwise be lost to businesses, state and local government and to the Federal Government. According to the Financial Management Service of Treasury, private collectors currently handle 80 collection programs for Federal agencies, including the Department of Education, where since 1982, we have collected more than \$1 billion in delinquent student loans, including \$650 million in the last two years alone.

In the last few weeks, an ACA member, National Credit Management Corporation (NCMC) of Hunt Valley, MD., received a contract from the Nuclear Regulatory Commission (NRC), the Federal Trade Commission and the Comptroller of the Currency to provide demand letters, a collection service where the collector sends letters to debtors asking for payment. The contract, which any Federal agency can use, pays NCMC 54 cents for each letter sent. In addition, the company is paid for any additional work such as searching for assets. In just a few short weeks, this company has collected \$141,895 for the Federal Government at a cost to the Government of only \$1,175,30.

Now, compare this to what it costs the Government to send a letter. A senior official at the Office and Management and Budget has told me that the agency estimates that it costs the Government \$24 to send a single letter, when all costs are factored in-personnel, equipment, material, etc. Simple math tells us that it would save the Government \$23.46 a letter to use the services of a company such as NCMC. Only three agencies are using the NCMC contract, even though it has been available to all departments for some two years

Since this hearing is to deal with the Internal Revenue Service, let me move quickly to the main topic. Private collectors currently collect taxes in 32** states, including you home state of Connecticut Madam Chairwoman. According to a 1994 General Accounting Office study, the states generally give high marks to these private collectors. We note that the GAO study shows a gross recovery rate for private collectors doing state tax collections as high as 45%

^{**}Alaska, Arkansas, California, Colorado, Connecticut, Delaware, Hawaii, Illinois, Iowa, Kansas, Kentucky, Maine, Maryland, Michigan, Minnesota, Mississippi, Missouri, Montana, Nebraska, New Mexico New Jersey, North Carolina, North Dakota, Oklahoma, Pennsylvania, Tennessee, Utah, Vermont, Washington, West Virginia, Wisconsin and Wyoming.

As we move to the Federal IRS program, it is important to remember the timeliness concept. The current IRS Request for Proposal (RFP), based on the age of accounts, is certainly not a true test. In the pilot program, of the accounts that are in the business tax category, 91% are more than three years old and 52% are more than six years old. In the individual area, 77% are more than three years old and 28% are aged over six years old. At the same time, in both categories, of the accounts being turned over to private collectors only 3% are under one year old.

It is ACA's belief that the collection of delinquent taxes, either at the state or federal level has a direct bearing on the timeliness with which the accounts are turned over to private collectors. A study done by ACA clearly illustrates that point. For example, on accounts placed for collection within 30 days of delinquency, the average recovery rate is 53%. After 90 days, the rate drops to 29% and after one year, the rate falls to 10 percent. When an account is placed after 421 days of delinquency, the collection rate is only 4%. We do not have adequate statistics to show the collection rate on accounts that are two, three, five or more years old. We do know however, based on experience in collection student loans that government loans that are multi-year delinquent have a much higher private collection rate than similar aged accounts in the private sector. So even the older IRS accounts can be collected if turned over to private collectors.

In discussing the IRS collection program, the first and most important given is that the IRS wants to collect delinquent taxes. If that is not given, then the alternative is to continue with the current system, which according to GAO sees an increase of 8% a year in uncollected delinquent taxes.

Currently, IRS has some \$200 billion in delinquent taxes facing collection. In the last two years, IRS had to "write off" \$60 billion in delinquencies that fell into the Currently Not Collectible (CNC) category. That is \$60 billion that is most probably lost to the Treasury forever. unless it it turned over to private collectors. As this Congress struggles with budget constraints, wouldn't it be nice to have that \$200 billion to either help fund the Government or to be used to reduce taxes. How many new roads could be built with that money? How many child care facilities built and could a cure for cancer or AIDS be discovered with those funds that will be lost if we don't act"

Here is what ACA proposes. Let IRS work those accounts that are the most current and have the highest dollar value. Once an account reaches 180 days past due, it would be transferred to Financial Management Systems in the Treasury where it would be sent out for collection by private companies. This would not result in the loss of any jobs at IRS and would allow the agencies to better use their in-house collectors. Most importantly, it would increase the amount of tax dollars collected directly and would greatly reduce the accounts that would have to be written off.

ACA believes that the only way to solve the current IRS collection problem is with direct legislation and the longer the wait for passage of that legislation the greater the loss to the Treasury.

There are those who say nothing should be done until the end of the IRS test program—that is wrong. The test program has been designed in such a way that it will not be a true or even fair test. The requirements of the program are so cumbersome, the cost to a collection agency that win a contract are so high and the potential return so small, that many outstanding collection firms that should be bidding on this contract are sitting this one out.

What is even more shocking about the IRS test program is that it is a direct slap in the face at the Congress. The House committee report on the legislation establishing the test program said"...to insure that the initiative receives an opportunity to flourish...the Committee is adamant that the IRS assign cases that "would fit the profile of a private sector collection agency." Certainly when 91% of the accounts in the business category are over six years old, hardly meets the Committee's directive. But even more shocking was the IRS's totally disregard for the Committee's direction that the "Committee insists that the contracts should include the opportunity for smaller collection agencies to participate.

Pecause of the myriad requirements in the contract including a \$300 investigation fee for every employee who works on the contract, no "smaller" collection agency can afford to take a chance on this contract. The best opportunity for small businesses, then, would be as sub-contractor, a practice that many large collection agencies follow. Not only does the RFP discourage subcontracting, however, but, in response to a question from a collector who wrote, "Does the IRS expect the direct subcontracting of the actual collection work to small business?" The IRS wrote "Absolutely Not." In fact, a contractor, who sent accounts to a smaller collector would be in violation of the security requirements of the contract. So much for the "Committee insists."

One of the common misunderstandings about collection work, particularly if it is for the IRS, deals with privacy. Collectors don't want copies of tax records. They simply want name, address, telephone number, amount owed and employment information, if possible. I would point out that under the Fair Debt Collection Practices Act, passed in 1977, even the disclosure of that basic information to a third party by a collector would be a violation of the Act and subject the collector to severe monetary penalties. Earlier I mentioned that the Department of Education has used outside collector since 1979. During that period the agency has not received a single complaint about a collector violating a borrower's privacy. By contrast, since 1989, some 1,300 IRS employees have been caught snooping into taxpayers records. Who has the privacy problem?

In conclusion, Madam Chairwoman, if the Congress wants tax delinquencies reduced, less writeoffs, and reduced collection costs to the Government, then require the IRS to turn over accounts to FMS when they become six months delinquent and let the private collection agencies do the job that they do every day for every sector of the business world. If you want results, at a small cost to the Government and I might add, if we don't collect, we don't get paid, then using cost effective private collection agencies is the course to follow.

Thank you very much.

Chairman JOHNSON [presiding]. Thank you, Mr. Prins. Mr. Moskowitz.

STATEMENT OF SAUL L. MOSKOWITZ, PARTNER, DEAN BLAKEY & MOSKOWITZ

Mr. Moskowitz. Madam Chairman, Mr. Cardin, thank you for allowing me the opportunity to testify before the Subcommittee today on IRS debt collection activities.

My name is Saul Moskowitz and I am a partner in the Washing-

ton law firm of Dean Blakey & Moskowitz.

My background in student loan collection policy, which is what I am here to talk about today, is described, in detail, along with

the points I am making in my written statement.

I have 17 years' experience with student loan collection issues as a government attorney, as a policy director for the Student Loan Program, and in private law practice, working with various members of the industry.

The 17 years of experience that the Department of Education has in student loan collections can teach us quite a bit about what would happen if the IRS used these private collection firms to work the debt that the IRS has now given up on, or at least is not actively collecting.

The results which are described in more detail in my written testimony—and you can refer to appendix C, if you like, which kind of goes through this—what I believe would result is, number one,

billions of dollars in new revenue.

There are approximately \$40 billion of accounts receivable in the, what they call the ARDI at the IRS, the accounts receivable dollar inventory, that are not actively pursued today by the IRS, that I believe are appropriate for referral to PCAs, private collection

agencies.

These include the deferred accounts, the accounts that have been in the collection queue for more than 90 days, and the accounts classified as CNC, currently not collectible, because of the IRS' inability to locate the debtor, to contact the debtor, even though they know where the debtor is, or that have been categorized as CNC because of a lack of known assets or income to pay the debt without financial hardship.

Private collection agencies have been collecting more than 19.6 percent of student loan debt referred to them, even though those accounts are harder to collect than many of the receivables I have

just described.

The reasons for that, I will be happy to go into with you, and

they are set forth in detail in my written testimony.

It is important to note that this 19.6 percent is net of the fees paid to the private collection agencies. The second thing that would

result is taxpayer privacy would be fully protected.

How do we know? The Department of Education—and I am not telling anyone who has been experienced lately in applying for Federal student financial aid, anything they do not already painfully know—the Department of Education receives more confidential financial information from a student loan applicant than the IRS gets from many taxpayers. Yet there has never been, as Curtis pointed out, a single unauthorized disclosure we know about, of

that information by a private collection agency collecting student loans.

There is no magic to it, they simply are not given access to this information and what they do not have, they cannot disclose.

Third, debtor complaints would be extremely rare. The Department of Education receives less than one complaint for every 50,000 debtor contacts by their PCAs.

The fact is the contractual penalties, the applicable legal requirements, and the contractor selection process, in the first place, ensure that debtor harassment does not take place, and the compensation scheme, which has been maligned over the course of this hearing, actually works to help this because it makes sure the collection efforts are focused on the truly collectible accounts.

It is simply a waste of money for a private collection agency, paid on a contingency-fee basis, to spend time going after a debtor who

truly is unable to pay.

Fourth, inherently governmental functions would not be usurped. The department's contract ensures that inherently governmental functions such as resolving disputes with student loan debtors, initiating litigation against those borrowers, that these are performed only by government employees.

Similarly, the IRS could, by contract, ensure that private collection agencies do not assess tax liabilities, do not resolve tax disputes, and do not seize assets, issue levies, or garnish wages. It is

a matter of what you put in the contract.

Finally, no appropriated funds would be needed. The Department of Education, as with all other Federal agencies, other than the Customs Service and IRS who are excluded, under the Debt Collection Act, can pay collection firms from proceeds collected.

Each of these points, as I mentioned, is reviewed in more detail

in my testimony.

Finally, with respect to the RFP, I have taken a close look at the RFP, and I have compared it to what the Department of Education uses in its contracts as a result of its 17 years of experience, and my analysis indicates that the RFP is deficient in numerous respects and is not going to produce useful information with respect to the use of private collection agencies.

The detail on why I say that: Again, there is an appendix to my testimony that gets into it. Briefly, the series of accounts that are included exclude important categories of accounts. The private collectors are not given critical information, basic information, like the

debtor's telephone number to use, to locate the debtor.

The system of online telephone transfers is doomed to failure, and the compensation approach is going to discourage diligent ef-

forts, not encourage them.

I should mention the IRS did confer with the Department of Education in developing the RFP, and yet makes the same mistakes that the Department of Education made and learned from years ago.

It clearly could have made better use of the expertise that resides there.

In conclusion, I would like to emphasize that private collectors have been used, successfully, not only by the Department of Education, but also by—I understand now we are at 39 States and growing, with respect to tax collection, and over 1 million private creditors.

Thank you very much for the opportunity to appear today and I will be happy to answer any questions.

[The prepared statement and attachments follow:]

STATEMENT OF SAUL L. MOSKOWITZ, PARTNER DEAN BLAKEY & MOSKOWITZ WASHINGTON, DC

Madame Chair and other members of the Subcommittee, my name is Saul L. Moskowitz and I am a partner in the law firm of Dean Blakey & Moskowitz in Washington, D.C. I am grateful for the opportunity to testify before the Subcommittee in support of the Subcommittee's oversight of IRS debt collection activities. With April 15 having just passed, and over \$200 billion owed to the Federal government in delinquent tax debt, this hearing is certainly timely.

INTRODUCTION

On behalf of a coalition of private collection agencies, I have been working with various experts on the IRS tax collection function to analyze the IRS Accounts Receivable Dollar Inventory (ARDI) and the extent to which the use of such firms would help improve the collection of federal taxes. Today my statement will focus on the experience of the Department of Education (ED) in collecting defaulted federal student loans and the lessons that experience can teach us about the use of private collection agencies (PCAs) to help collect delinquent federal taxes. For the reasons I will discuss today, I am convinced that, if PCAs were given a prominent role in collecting certain portions of the delinquent federal tax debt that is not now being worked by the IRS, billions of dollars in new revenue would be produced. Furthermore, this new money would be generated without compromising taxpayer privacy, harassing taxpayers, or involving PCAs in inherently governmental functions.

I. My Background in Student Loan Collection Policy

Prior to joining Dean Blakey & Moskowitz in 1990, I served at ED as an Attorney-Advisor in the Office of the General Counsel (OGC) from August 1979 until approximately February 1988. In that capacity, I provided legal advice to ED officials in connection with various programs, including the Guaranteed Student Loan (now the Federal Family Education Loan) Program (FPELP).

Beginning in approximately 1982, I became the lead program attorney for the FFELP. In that capacity, I was the primary attorney responsible for advising ED officials regarding the statutes, regulations and policies relevant to the FFELP. Through my daily consultations with program officials, I was intimately familiar with the policy decisions of ED regarding collection of defaulted loans.

In February 1988, I became Chief of the Guaranteed Student Loan Branch of the Division of Policy and Program Development within the Office of Student Financial Assistance. In this position, I served as principal policy official for the FFELP and worked closely with Debt Collection Management and Assistance Service in improving ED's collection of defaulted loans, including expanding and improving ED's relationship with its PCA contractors.

Since leaving ED in 1990, I have worked extensively with FFELP lenders, servicers, guarantors, and PCAs on student loan collection issues and have had numerous opportunities to see first-hand how these various parties pursue the collection of delinquent loans. During this period, I have also worked closely with PCAs that have contracts with FFELP guarantors and ED and have become very familiar with the structure of those contracts and the evolution of those contracts over time.

II. The FFELP

To understand FFELP defaulted loan collection procedures, it is essential to have a basic understanding of how the FFELP operates and, particularly, the extensive level of collection activity that defaulted loans undergo prior to being referred to PCAs by ED.

The FFELP is the largest Federal student aid program in higher education, providing over \$23 billion in funds to over 6.7 million borrowers in 1994 alone.

Under the FFELP, private lenders make loans to eligible students attending postsecondary institutions. These loans are guaranteed up to 98 percent by state or private nonprofit guaranty agencies. (Currently, there are approximately 47 guarantors throughout the country.) In turn, the guarantors are reinsured for up to 98 percent of the loan's balance by ED.

A flow chart illustrating the collection efforts that are undertaken on a delinquent FFELP loan is attached as Appendix A. As the chart illustrates, before a borrower defaults (defined as the failure of the borrower to make a payment on a loan within 180 days of its due date) and the lender files a claim with the guarantor for reimbursement, the lender must attempt to collect the loan for at least 180 days and must engage in at least the minimum collection efforts set forth in ED regulations. In addition, it must notify the guarantor of the delinquency. The guarantor then attempts to collect the loan at the same time the lender is doing so, in a process known as "pre-claims assistance". If all of these efforts fail, the lender may file a claim with the guarantor.

Upon paying the claim, the guarantor becomes the holder of the loan. The guarantor then commences 225 days or more of further collection action on the loan, culminating in litigation (or administrative wage garnishment) against the debtor if the debtor has sufficient assets or income. Also during this period, any Federal tax refund the debtor might be due is intercepted and applied to the debt.

FFELP guarantors have been quite proficient in their post-default collection efforts, collecting over \$2.2 billion in the last two (2) years, excluding amounts collected by tax refund offset. It is interesting to note that, with one exception, every guarantor contracts with private collection agencies (PCAs) to perform post-default collection activities.

Despite the collective efforts of the lender, the guarantor, and the guarantor's PCAs, some student loans remain uncollected. ED has the authority under the FFELP statute to require a guarantor to assign defaulted loans to ED. Accordingly, ED requires guarantors to assign various categories of defaulted loans on which the guarantor and lender have been unsuccessful in collection and on which litigation and/or administrative wage garnishment is not deemed to be appropriate. ED thereupon sends letters to the debtors in an effort to collect the debt. If these efforts fail, ED then places the debt with a PCA under contract with ED.

Thus, before a PCA under contract with ED gets a chance to collect a defaulted student loan, that loan has been deemed to be inappropriate for litigation or administrative wage garnishment, and has been through more than a year of exhaustive collection efforts by the lender, the guarantor, one or more PCAs under contract with the guarantor, and ED.

III. Department of Education Experience with PCAs

ED entered into its first contract with a PCA in 1979. ED's contract approach has undergone significant changes since then, resulting in steady improvement in the performance of contractors and the increased efficiency in ED's use of its resources to administer the contracts. PCAs collected more than \$650 million on defaulted student loans for ED in the last two years alone.

A. Contract Structure

Currently, ED is about to request proposals for a new series of contracts with 10-12 PCAs. The PCAs will compete head-to-head, with the top performers receiving substantial bonuses above the contractual commission percentage. As with the current contracts, contractor performance bonuses will be based on collections (net of fees), quality of litigation preparation and administrative resolution activities, and compliance with laws governing debtor rights and collection practices.

ED pays the PCAs from the amounts collected, as permitted by the Debt Collection Act. No appropriations are needed.

B. Collection Success Rate of PCAs

As noted above, PCAs receive loans from ED only after exhaustive collection efforts have been attempted by lenders, guarantors (including their PCAs), and ED. Moreover, none of these accounts are appropriate candidates for litigation due to the fact that the borrower is either unlocateable or does not appear to have sufficient assets or income to justify the cost of litigation. ED's PCA contractors are nevertheless recovering over 19.6 percent of the account balances referred to them. And that is after deduction of their fees.

C. PCA Activities Under the ED Contract

Under the ED contract, PCAs perform skip-tracing (attempting to locate delinquent borrowers) and telephone collection activities on referred accounts. They do not make personal visits, receive payments, resolve disputes, or sue defaulters.

The telephone collection efforts of ED's PCAs are designed to elicit information indicating whether or not the debtor has the income or assets to make payments on the debt, assist the debtor in understanding the options for resolving the default, and explain the consequences of the debtor's failing to do so. Since these

are, after all, telephone calls, any effort to harass or bully the debtor (in addition to being illegal and a violation of the contract) is likely to result in the debtor hanging up and refusing to cooperate further. Thus, the most common technique employs the so-called "indifferent" approach, with the collector reading (often in a flat monotone) from a prepared script. At the first sign of a willingness to cooperate from the debtor, the collector offers to assist the debtor in understanding and selecting the best option for resolving the debt. Because of the collector's training and expertise, he or she is often able to obtain cooperation from the debtor where others have failed. Thus, the stereotype of "Bruno from New Jersey" bears no resemblance to the actual telephone collection techniques used by PCAs on defaulted student loans.

PCAs are successful because they employ state-of-the-art credit-scoring techniques to identify the most collectible accounts and are able to access sources of borrower and asset location information that are often unavailable to lenders, guarantors, and ED. However, probably the most important element in a PCA's ability to collect a student loan where others have failed stems from its ability to provide substantial performance incentives to individual collectors. These incentives help collectors maintain their enthusiasm in the face of what can often be an extremely unpleasant job. After all, most student loan defaulters are not happy about being contacted for collection of their debt by anyone. They are usually uncooperative, and often abusive with whoever performs that function. By providing a system of performance incentives that no government agency can match, PCAs have succeeded where lenders, guarantors, and ED have failed.

D. Frequency of Borrower Complaints

PCAs working for ED generate an extraordinarily low volume of debtor complaints, the vast majority of which are baseless. In fact, ED receives less than one complaint for every 50,000 contacts with debtors by its PCAs.

E. Debtor Privacy

Debtor privacy is a critical concern in the student loan program due to the extensive personal financial information that an applicant must provide to ED to get a loan in the first place. PCAs have posed no problems for ED in this area.

In order to qualify for an FFELP loan, a student must first fill out the "Free Application for Federal Student Assistance", or "FAFSA". A copy of this form is attached to my testimony as Appendix B. ED uses the information on this form to determine the student's eligibility for Federal aid, including FFELP loans.

The FAFSA requires the applicant to submit extensive information regarding educational plans and student status. In addition, and of particular relevance here, the FAFSA requires the applicant to provide ED with detailed financial information taken directly from the student's and his/her parents' tax returns, as well as detailed information concerning the student's and parents' assets. Thus, the confidential financial information an individual must provide to ED in order to receive an FFELP loan often exceeds the information provided to the IRS on a taxpayer's Form 1040.

Yet, ED's PCAs have <u>never</u> disclosed any of this information to third parties. This is simply because they are <u>never provided access</u> to that information. The fact is that a PCA does not need this information to do its job. ED's PCAs are only provided with the information necessary to assist them in locating and contacting the debtor regarding the debt, such as debtor address and telephone number, employer name, employer address and telephone number, and the amount of the debt.

F. Regulatory Incentives for Use of PCAs by Guarantors

ED's belief in the benefits of using PCAs is reflected in the requirements it imposes on quarantors.

The FFELP regulations mandate detailed collection activities that a guarantor must follow on a defaulted loan in order for the guarantor to be reimbursed for its default claim payments by ED. However, if a guarantor uses PCAs in a "competitive environment" that rewards the best performers, the regulations relieve the guarantor of significant portions of those requirements and allow the PCAs to collect as they see fit. This is because, quite simply, ED believes that a guarantor that uses multiple competing PCAs has, by that step alone, ensured that the defaulted loans held by the guarantor will be collected in an efficient and effective manner.

IV. Analysis of IRS Accounts Receivable Dollar Inventory (ARDI)

In order to assess the relevance of ED's experience with PCAs to the IRS, I have consulted a number of experts on IRS collection matters, including IRS experts at Coopers & Lybrand. This analysis indicates that several segments of the ARDI bear a close resemblance to the student loan accounts that PCAs have successfully collected.

Based on recent data provided by the IRS to the Subcommittee on Government Management, Information & Technology of the House Government Reform & Oversight Committee, several large blocks of accounts in the ARDI, together totalling more than \$40 billion, appear to be excellent candidates for referral to PCAs. These categories are as follows:

- 1. <u>Deferred Accounts (approximately \$1.8 billion according to the IRS)</u> -- These accounts are below the IRS dollar threshold for further active collection efforts, but are probably very collectible. For example, the State of Illinois has reported that, when it referred similar "older-year" state income tax receivables to PCAs, approximately 30 percent of the debt was collected.
- 2. Accounts in the Queue for More than Ninety (90) Days (amount presently unknown, probably exceeds \$5 billion) -- These accounts have received a low "RMS score" by the IRS, indicating that IRS believes they should not receive priority for referral to revenue officers.
- 3. "Currently Not Collectible" (CNC) Accounts So Classified Due to IRS' Inability to Locate or Contact the Debtor or the Debtor's Lack of Known Assets or Income (approximately \$35 billion according to the IRB) -- These accounts have been determined to be "currently not collectible" by the IRS.

These categories of accounts in the ARDI are at least as collectible, and probably more collectible, than the student loan accounts that PCAs collect for ED on a daily basis. This is true for several reasons:

a. <u>Source of the debt</u>. It is important to remember that the FFELP is designed to induce lenders to make loans to disadvantaged students who could not otherwise receive credit, so that those students can obtain a postsecondary education. By definition, these borrowers have little or no assets or present income, only the hope of future income. Moreover, according to the latest ED data, 56 percent of the loans being collected by PCAs under contract with ED were made to borrowers who attended for-profit trade or technical schools. Many (if not most) of those defaulters failed to complete even that level of training. Thus, the income prospects of the typical student loan defaulter are usually quite modest, not at all the "deadbeat doctor" paradigm that is sometimes portrayed in the media.

In contrast, the taxpayers who owe the amounts to the IRS indicated above at one time had income significant enough to generate the tax liabilities that now remain uncollected.

- b. <u>Prior collection efforts</u>. As noted above, PCAs only receive referrals from ED of accounts that have already been the subject of exhaustive collection efforts for over a year and have been deemed to be inappropriate candidates for administrative wage garnishment or litigation. This level of prior effort greatly exceeds the effort expended by the IRS on most of the ARDI accounts described above.
- c. <u>Debtor resources</u>. Even ARDI accounts that the IRS has determined cannot be collected because the debtor lacks assets or income are assigned to that status only based on <u>assets or income that the IRS knows about</u>. Obviously, the hundreds of billions of dollars of income generated annually in the so-called "Underground Economy" are not taken into account. Further, a debt can remain in inactive status for as long as three (3) years even after the government receives information indicating that the debtor has acquired assets or income that could be used to pay the debt.

V. ED's Use of PCAs --Lessons for Federal Tax Collection

The Department of Education's experience with PCAs described above teaches us several lessons about what results could be expected if PCAs were given a prominent role in the collection of those portions of the ARDI described above under contracts similar to that used by ED. A summary of these points is attached to my testimony as Appendix C for your reference.

Specifically, ED's experience shows that, if IRS issued contracts similar to ED's allowing PCAs to collect delinquent federal tax debt not now being worked by the IRS, the following would result:

- 1. Billions of dollars in new revenue. PCAs are netting back to the government more than 19.6 percent of the student loan debt referred to them, even though, as discussed above, those accounts are <u>harder</u> to collect than many of the receivables IRS has given up on.
- 2. Taxpayer privacy would be fully protected. As noted, ED receives \underline{more} confidential financial information from student loan applicants than the IRS receives from many taxpayers, yet there has never been an unauthorized disclosure of that information by a PCA collecting student loans. This is simply because the PCAs are $\underline{not\ qiven\ access}$ to this information.
- 3. Debtor complaints would be extremely rare. ED receives less than one complaint for every 50,000 debtor contacts by PCAs, and the vast majority of these complaints are baseless. Contractual penalties and applicable legal requirements effectively deter debtor harassment, and a compensation scheme based on dollars collected ensures that PCAs concentrate on truly collectible accounts.
- 4. Inherently governmental functions would not be usurped. ED's contract ensures that inherently governmental functions such as receiving payments, resolving disputes, and initiating litigation against debtors are performed only by government employees.
- 5. No appropriated funds would be needed to pay the PCAs. ED pays PCAs' fees from amounts collected, as permitted by the Debt Collection Act.
- It is important to note that ED's positive experience with PCAs is far from unique. More than 32 states use PCAs to help collect delinquent state tax debt. As with student loans, large amounts of new revenue are collected without loss of taxpayer privacy, harassment of debtors, or usurpation of inherently governmental functions.

VII. Recommended Structure of IRS Contracts with PCAs

In order for IRS to duplicate the success ED has enjoyed in using PCAs, IRS should adopt the contract structure and compensation approach that ED has developed over the past 17 years. Instead of "reinventing the wheel", IRS has the opportunity to learn from the ED experience.

The key components of an IRS contract with PCAs would include the following:

- 1. **Competitive environment.** Experience shows that, when PCAs are required to compete head-to-head for bonuses and additional placements, performance is maximized.
- 2. Modified commission compensation structure. A commission-based compensation approach is necessary to produce excellence in performance and to ensure that the PCAs concentrate on the most collectible accounts. In fact, this approach creates a strong <u>disincentive</u> for pursuing debtors lacking the means to pay the debt. The basic commission should be supplemented by substantial bonuses and penalties based on performance, with performance measured by net collections, compliance with procedural and technical requirements of the contract, and compliance with all applicable laws protecting the rights of debtors.
- 3. Prohibit access to taxpayer financial information. As noted above, it is not necessary for a PCA to have access to a debtor's financial information in order to efficiently collect the debt. To do its job, all the PCA needs is "directory information", such as address, telephone number, employer information and type and amount of debt.
- 4. Inherently governmental functions should not be delegated. As with ED's contract, IRS's contract should specifically enumerate the activities that the PCA may undertake, so as to prevent the PCA from performing such inherently governmental functions as receiving payments, resolving disputes, seizing assets, issuing levies, or initiating litigation against debtors. PCAs should be limited to locating debtors and assets and engaging in telephone collection efforts.

In addition, I would recommend that IRS closely examine the contracts issued by the many states that have successfully used PCAs to help collect state tax debt.

For its part, Congress needs to insure that the IRS, which has recently reversed its long- standing position and now opposes use of PCAs, carries out the contract in a good faith effort to maximize its effectiveness. As discussed below, the numerous deficiencies in the Request for Proposals issued by the IRS on March 5th to pilot test the use of PCAs cast some doubt on the willingness of the IRS to put forth such an effort. Accordingly, the Congress should consider tying IRS appropriations to its performance in carrying out PCA contracts and/or assigning the task of issuing and administering such contracts to the Financial Management Service (FMS) within the Department of Treasury. Unlike the IRS, the FMS is enthusiastic about the use of PCAs and has carefully studied the ED approach in an effort to improve the collection of other non-tax debt owed the Federal government.

VIII. IRS Request for Proposals to Pilot Test the Use of PCAs

I have closely examined the March 5, 1996 Request for Proposals (RFP) issued by the IRS to pilot test the use of PCAs to collect delinquent tax debt, and have compared it to the contract terms and structure of the ED contract with PCAs. My analysis indicates that the IRS RFP is unlikely to produce useful information regarding use of PCAs. The IRS RFP omits important categories of accounts in the ARDI from the test, prevents the PCAs from doing a good job by withholding critical information (such as the telephone number of the debtor), creates an unworkable system of on-line telephone call transfers, imposes extremely onerous upfront expenses on contractors, and employs a compensation approach that is likely to discourage diligent collection efforts by the contractors. The specific problems I see with the RFP are described more fully in the Critique attached as Appendix D to my testimony.

Although it is my understanding that IRS conferred with ED in the development of its RFP, the RFP makes many of the same mistakes that ED made, and learned from, years ago. Clearly, IRS could have made better use of ED's expertise in drafting the RFP.

CONCLUSION

PCAs have been used successfully by the Department of Education, dozens of states, and over 1 million private creditors for many years. With over \$200 billion in delinquent federal tax debt now outstanding, the question is -- why not the IRS?

Thank you very much for the opportunity to appear before you today. I would be happy to answer any questions you may have.

Chairman JOHNSON. Thank you very much, panel, for your comments.

Mr. Cardin.

Mr. CARDIN. Thank you, Madam Chairman.

First, let me thank all three of you for your testimony. Mr. Moskowitz, I could not agree with you more, that the classification of debt is the first step in trying to collect debt. That some debt just is not worth going after. The commercial enterprises can write off debt. IRS does not write off debt unless it meets certain standards, that are certainly not commercial standards.

So we have an immediate problem in that we tend to group into our accounts receivable for debt certain items I think the private sector would not so generously list as, realistically, receivables.

The student loan analogy goes a certain way. I mean, clearly, there has been success in private collection agencies with student loans.

But the Internal Revenue Code is much more complicated. We are trying to deal with the complications of the Internal Revenue Code in this Subcommittee in looking at alternative tax structures to the current way that we collect revenues.

The Internal Revenue Service is not only instructed to collect revenues, but to make sure that there is compliance with the Code. And there are certain parts, and relief that a taxpayer can receive, that is not analogous to the private sector.

When you get from a commercial enterprise a debt to collect, your responsibility is to collect that debt, whereas, the Internal Revenue Service's responsibility is not only to collect the debt, but to make sure there is compliance with the Code.

So no matter how many requests I get to my office about tax-payers who are having a concern with the IRS on collection, and their concern that the Code has not been complied with, I guess my question would be, How would you proceed if you just get the basic information—the name, address, telephone number, employment, and the taxpayer you are able to reach says, "Well, I had a conversation with the IRS," or "I believe that I do not owe them money under IRS rules because here is my income, here is this," and starts to go through some of the specifics. How do you deal with that if you are going to stay pure to not getting the information that would be on a tax return?

Mr. Moskowitz. That is a very good question, Mr. Cardin, and it is a question—and my friends who deal with some of the most complex health care programs, for example, I am convinced that the Student Loan Program is at least as complicated, if not more so than, say, Medicare or Medicaid.

Do not underestimate the complexity of the Student Loan Program, and by the same token, of course, I would not want to gain-say the complexity of the Internal Revenue Code.

Mr. CARDIN. Yes. Do not underestimate the complexity of the IRS Code.

Mr. Moskowitz. I do not think it is possible to overestimate it. Having said that, the Student Loan Program involves a great deal of variety in the kinds of relief borrowers can get, and a lot of issues about eligibility and educational costs that we simply, just as

with the Internal Revenue Code, we do not want private collectors making those kinds of decisions, resolving those kinds of disputes.

It seems to me the inherently governmental function we are now talking about is the resolution of a tax dispute, and just as with the resolution of the amount of a debt in the Student Loan Program, as soon as a dispute becomes apparent in the Student Loan Program, that debt is pulled from the private collection agency and is sent back to the Department of Education with the people with the expertise to resolve those questions. That is the way I believe the IRS should proceed on its contracts as well, and I believe it does in the RFP.

I have said some bad things about the RFP. I do believe it is flawed in numerous critical respects, but on this point I think it does the right thing, which is if a dispute is raised by the taxpayer, the account is pulled, it goes to the IRS who makes the call on the tax issue.

Mr. CARDIN. I would point out there are very few people who owe money who will not raise some excuse for not paying or some justification for not paying, and you need to have some degree of subjectivity in determining when it is a real dispute over the underlying debt and when it is just an excuse to try to avoid payment.

So there has got to be some subjectivity in these determinations, and I guess that is the concern many of us have when you are deal-

ing with IRS debt.

Mr. PRINS. Mr. Cardin, if I could answer that.

Under the pilot program, once the situation that you have suggested arises, the collector has to, at that point, turn the taxpayer or the tax delinquent, if you will, over to an IRS official. There is a transfer of the phone call from the collector to IRS officials in their field office, who goes through those problems and works it out.

Let me also suggest one of the problems with that is if we locate the taxpayer, someone who has been missing for years, and the taxpayer refuses to talk to the IRS, but we give them the name, the address and the phone number, but the gentleman or the person will not talk to IRS, we do not get paid a dime for that.

So there is no incentive for us to argue with taxpayers.

Mr. CARDIN. Thank you all.

Chairman JOHNSON. I was very interested, Mr. Prins, in your written statement, and I did not catch this in your oral statement. But there was very clear direction from the Congress that the program to pilot privatization of debt collection include a reasonable sampling of collectible debts.

In your testimony, you say that—I think it was 91 percent are

over 6 years old.

Mr. PRINS. Ninety-one percent of all of the debts are over 3 years old in the business category, and 51 percent are over 6 years old. Only 3 percent of all the debts in the pilot program are under 1 year old.

Chairman JOHNSON. That is extremely distressing, because in the end, this is not about 6-year old debts. This is not about 3-year-

old debts.

What we are trying to do is see if you collect debts promptly, if, after the first round of effort fails, and you move into a different

system immediately, then are you going to prevent the 3-year and

6-year problems from developing.

So it would be more realistic to have no problems that were more than 3 years old than the opposite. But that is very distressing, that such a high number are old.

Mr. Lane, did you want to comment?

Mr. Lane. I think the reason that it is structured that way, from my understanding of the RFP, is that what IRS wanted to see was if these commercial collection agencies had the ability to either initiate contact with a taxpayer they were not able to locate, so therefore the case had been in what is called the queue, or the deferred work that they mentioned earlier.

So that is one of the reasons you get this stuff so old. By the time

you go through the IRS notice process, it is 18 months.

Chairman JOHNSON. As I made clear earlier in the hearing, I am very interested in a far more aggressive effort to collect from that category where location is an issue, where communication is an issue.

But a pilot program should not direct itself to that uniquely difficult collection group, especially when below a certain threshold no center in America is going after delinquent taxpayers who may be

1 year, 6 months, $1\frac{1}{2}$ years behind with small amounts.

Mr. Lane. The problem I have with this—and I ran out of time, but if I could bring it out in this question—the way the RFP is structured—and that is the problem we have, primarily, is with the production quota environment.

If you gave brandnew cases to these collection agencies, under the terms of the program, if they got a full pay, they would get

eight times what they contracted for on that case.

Now let us say you had a \$500 delinquency, and they paid \$50 a case to get it. IRS would be paying them \$400 to collect that \$500.

At the same point, if they had a two——

Chairman JOHNSON. I do not follow that. Why would they not get \$50?

Mr. Lane. Because there is a graduated bonus structure in here based on the disposition of the case. This is what our big complaint is about. Let us say the collection agency bids IRS, they will pay \$50 for each case, for the right to work that case.

Under this proposal—it is spelled out in the RFP—if the collection agency gets a full pay on that, in other words, the taxpayer sends them a check, the IRS will pay a bonus of eight times the

\$50 to the collection agency.

Now you literally have a situation where if they collected \$300, they would get paid \$400 by IRS. You literally could have IRS los-

ing money in this for every full pay.

Chairman Johnson. Well, we will look back more carefully on the RFP, because a number of issues have been raised about it here today. But I would hope that the enrolled agents would work with us on what kind of private sector program we ought to have.

Mr. LANE. We gave the Subcommittee five suggestions, where they could utilize law firms and public payroll services. Five separate suggestions where you could take the same \$13 million, put it in an environment where you did not address the concerns we have about the violation of taxpayer rights and undefended people dealing with these commercial collection agencies.

Chairman Johnson. Thank you very much.

Mr. LANE. Thank you.

Chairman JOHNSON. We certainly are committed to protection of taxpayers. I have been very interested at the small amount of information that collection agencies need to do their job, and this has been a very fruitful hearing for us.

I thank you very much for your participation.

Mr. Lane. Thank you for your invitation. Chairman JOHNSON. The hearing will conclude.

[Whereupon, at 12:47 p.m., the hearing was adjourned.]

[Submissions for the record follow:]





APRIL 25, 1996

WRITTEN STATEMENT OF THOMAS A. SCHATZ, PRESIDENT, CITIZENS AGAINST GOVERNMENT WASTE

BEFORE THE

COMMITTEE ON WAYS AND MEANS, SUBCOMMITTEE ON OVERSIGHT

UNITED STATES HOUSE OF REPRESENTATIVES

APRIL 25, 1996

Madame Chair, as President of Citizens Against Government Waste. I appreciate the opportunity to offer this testimony concerning the problem of uncollected delinquent tax debt. Our concern about this issue corresponds with our ongoing effort to expose what we consider to be examples of waste of the taxpayers' money.

I am deeply concerned about the \$200 billion in delinquent federal taxes currently outstanding and I call on this committee to consider a new approach to this serious problem. Unrecovered revenue represents billions of dollars which could be used for deficit reduction, tax relief, or other important public investments.

Despite the efforts of the IRS, this boondoggle is getting steadily worse. The IRS's inability to control the growing gap between what is owed and what is actually collected each year is evidenced by the dramatic \$29 billion jump in IRS accounts receivable since just last year alone. This drain on the federal treasury is forcing honest taxpayers to pick up the tab for deadbeats and it must be stopped.

I strongly urge the committee to give serious and swift consideration to using all reasonable, effective tools to combat this growing deficiency. There is no good reason the IRS should not turn some of the responsibility for collecting these overdue accounts to the private sector. The successful use of private collection agencies by thirty-nine states and numerous federal entities, including the Department of Education, proves that private collection works.

As this committee grapples with how to stem this drain on the federal treasury, the private sector should be considered as part of an overall strategy. Taxpayers deserve a frontal assault on this problem. They will not understand why a solution with a proven track record of success -- one that costs them nothing -- is not at least given a try.

WRITTEN STATEMENT OF THE FAIR SHARE COALITION

The Fair Share Coalition was established in January 1996 to support legislation requiring the IRS to use private collection agencies (PCAs) in the collection of delinquent federal tax debt. It is comprised of four PCAs with extensive experience in collecting government receivables. With over \$200 billion in delinquent accounts receivables owed the IRS, this step is long overdue and is necessary to ensure that all taxpayers pay their "fair share." Below is a discussion of some of the issues that surround this proposal.

I. SHOULDN'T CONGRESS WAIT UNTIL AFTER THE RESULTS OF THE IRS DEMONSTRATION PILOT ARE IN BEFORE PROCEEDING FURTHER WITH THIS IDEA?

No. This idea has already been thoroughly tested with extremely positive results at the state level by 39 state tax authorities, at the federal level by most federal credit agencies, and in the private sector by over one million businesses.

Secondly, waiting 2 1/2 years will cost the taxpayers large amounts of revenue that will never be recovered.

Finally, after careful review of the Request for Proposals (RFP) issued by the IRS on March 5, 1996, it is our opinion that, unless substantial modifications are made in the approach the IRS has proposed, the Pilot will produce little if any helpful information regarding the ability of PCAs to help collect delinquent tax debt.

- Omission of deferred accounts;
- Omission of CNC cases so classified based on the debtor's lack of known assets/income;
- Critical location information such as debtor's phone number, and employer address and phone number will not be provided to PCAs by the IRS;
- PCAs will not be given asset location authority;
- Enormous start-up costs are involved;
- 6. The requirement that PCAs have an IRS representative on site at all times while carrying out their duties under the contract will greatly impede productivity due to restricted working hours of IRS staff;

- PCAs must pay IRS a \$300 investigation fee for each employee working on cases referred by the IRS; and
- 8. A counter-productive compensation structure.

II. AREN'T THE COLLECTION ACTIVITIES CONTEMPLATED BY THIS LEGISLATION "IMBERENTLY GOVERNMENTAL" IN NATURE AND TRUS SHOULD ONLY BE PERFORMED BY GOVERNMENT EMPLOYEES?

No. The collection activities that would be authorized under this legislation include merely locating debtors, conducting credit checks, mailing collection notices, and making collection calls. The Office of Management and Budget (OMB) has specifically confirmed that these activities are <u>not</u> "inherently governmental" in nature and are appropriate subjects for contracting out by the IRS.

The legislation would not authorize PCAs to receive funds, compromise debts, sue debtors, seize property, or levy against assets. Because these activities are considered "inherently governmental" by OMB, the power to perform these activities will remain solely with IRS collections staff.

III. WOULDN'T THIS LEGISLATION LEAD TO BREACHES OF TAXPAYER PRIVACY?

No. Under the legislation, PCAs would not have access to entire individual tax return information. The only information that would be disclosed to PCAs by the IRS is the debtor's name, address, telephone and social security numbers; the employer's name, address and telephone number; and the type and amount of the debt owed.

In addition, to date, in the millions of collections that PCAs have undertaken for debts owed the U.S. Department of Education, there has been no documented case of breach of privacy.

IV. WHAT TYPE OF FEE ARRANGEMENT WOULD THESE CONTRACTORS BE COMPENSATED UNDER?

Under the Horn proposal (H.R. 2234), PCAs would be compensated on a modified contingency fee basis ($\underline{i.e.}$ PCAs would keep a percentage of the proceeds they collect).

Although the Taxpayers' Bill of Rights (TBOR) prohibits the evaluation of IRS employees on the basis of their performance, the

Debt Collection Act of 1982 specifically authorizes contingency fee arrangements for government contractors. Over the years, the Department of Education has thoroughly reviewed the issue of compensation arrangements with its contractors and has found that the contingency fee arrangement produces the best results. In addition to providing adequate incentive to the PCAs under the contract, the contingency fee arrangement is appealing because PCAs would be paid directly out of the proceeds they collect, eliminating the need for any Congressional appropriation.

Under the Horn proposal, the IRS contracts would be modeled after the Education Department contracts. Specifically, the base compensation for the contractors would be calculated as a percentage of account dollars collected or included in repayment schedules agreed to by debtors. Also, as with ED, a competitive environment would be structured that would reward productive contractors who comply with the law and do not generate debtor complaints, and penalize unproductive and noncompliant ones.

V. WOULDN'T THIS LEGISLATION TAKE JOBS AWAY FROM FEDERAL WORKERS?

No. Under this legislation, only tax debt not actively being pursued by the IRS would be referred to PCAs, so no IRS employees would be displaced. This legislation would simply complement the work of IRS collections staff by doing a job that is now being ignored.

VI. WOULDN'T TAX DOLLARS BE BETTER SPENT HIRING MORE IRS COLLECTIONS STAFF THAN BY CONTRACTING WITH THE PRIVATE SECTOR?

No. PCAs collect roughly \$5 for every \$1 spent for the Department of Education. In contrast, Robert Tobias, head of the National Treasury Employees Union (NTEU), stated at a September 1995 House Subcommittee hearing that IRS employees collect only \$3 for every \$1 spent. Furthermore, the IRS lacks the overall resources necessary to do an adequate job of collecting taxes and is far from acquiring technological advancements already being used by private collectors.

STATEMENT OF ROBERT M. TOBIAS NATIONAL PRESIDENT NATIONAL TREASURY EMPLOYEES UNION

The National Treasury Employees Union, (NTEU), is the exclusive representative of over 150,000 federal government employees, including all of the eligible employees of the Internal Revenue Service. On behalf of the men and women who collect the revenue for the Federal Government, I welcome this opportunity to submit written comments to the members of the Subcommittee on Oversight, Committee on Ways and Means, regarding tax debt collection issues.

NTEU shares the concern of the members of this Subcommittee that money owed to the Federal Government must be collected and used to reduce the federal deficit. We strongly believe, and our members have demonstrated, that the Internal Revenue Service can make a major contribution toward balancing the federal budget by 2002 if given the necessary resources on a consistent basis. As an example, in FY 1995, the IRS received the first year of funding for what had been a five (5) year plan to improve compliance and reduce the federal deficit. The FY 1995 accomplishments were impressive. The IRS closed an additional 676,000 examinations, audit coverage increased from 1.08 percent to 1.63 percent, and the IRS collected an additional \$803 million directly attributable to this compliance initiative. Clearly, the collection of tax liabilities during the first year of this five year initiative far exceeded the \$331 million that was originally projected. The IRS was well on its way to collecting the estimated \$9.2 billion in additional revenue which had been targeted for deficit reduction as a result of this five year tax compliance initiative. During the FY 1996 appropriation process, the second year of this compliance

initiative was not funded. As a result, the collection of millions of dollars in tax revenues was delayed. Such delays significantly increase the difficulty of collecting such liabilities.

Also during the FY 1996 appropriations process, Congress restricted an additional \$13 million of the current IRS budget to be used for a pilot program to test the use of private law firms and debt collection agencies to assist the Agency in collecting delinquent tax debt. IRS issued a request for proposals (RFP) on March 5, 1996. Proposals were due on April 12, 1996. As the IRS moves forward with the implementation of this private tax debt collection pilot program, NTEU would like to raise several issues that should be considered in assessing the overall success or failure of this pilot program and that must be considered prior to a decision being made with regard to the continuation of such a controversial policy.

TAX COLLECTION - AN "INHERENTLY GOVERNMENTAL" FUNCTION:

The Constitution of the United States provides Congress with the power to levy and collect taxes. While Congress has retained its Constitutional authority to levy taxes, it has delegated its authority to collect taxes to the Secretary of the Treasury. Any serious discussion regarding the contracting out of federal tax debt collection to private contractors must be preceded by an analysis of the legal issues inherent in such a decision. GAO testified before the Subcommittee on Oversight, Committee on Ways and Means, on April 25, 1996, that "there is an Office of Management and Budget (OMB) policy determination and IRS Office of Chief Counsel guidance that specify that the collection of taxes is an inherently governmental function that must be performed by

government employees." OMB defines an inherently governmental function as an activity that is "so intimately related to the public interest as to mandate performance by Government employees." OMB specifically cites the collection of taxes as an example of an inherently governmental function.

However, while the actual collection of taxes is, in fact, an inherently governmental function which cannot be contracted out to private contractors, GAO also stated in its testimony that "private collectors could perform collection-related activities such as locating taxpayers and attempting to secure promises to pay."

As a result, the question is not whether private contractors should collect tax debts, but whether private contractors should be used to perform collection-related activities. If such a decision is to be seriously considered, it is critically important that both economic considerations, e.g., return on investment, and taxpayers' rights and due process protections be addressed as intricate components of any future decision.

Our current federal income tax system is based upon the voluntary compliance of individuals and businesses. When a question arises regarding the amount of tax due or the legitimacy of an assessment, an inevitable tension arises between a taxpayer's rights, including his or her due process rights, and the authority of the government to collect taxes owed.

As an example of this tension, in a recent report entitled, <u>Internal Revenue Service Receivables</u>, 25-28, Report No. GAO/HR-95-6 (1995), the GAO stated that "the IRS may be sending the wrong message to its collection employees by such actions as prohibiting the evaluation of collection employees based on amounts collected, increasing the use of installment agreements, and making additional use of offers in compromise." In other

words, GAO raised the question concerning whether IRS collection employees should be offered incentives as a means of increasing rates of collection. On the other hand, Public Law No. 100-647, the "Taxpayer Bill of Rights" (1988) prohibits the IRS from making compensation or personnel actions such as performance evaluations based on the amount of revenue collected.

Congress has consistently sought to maintain a "balance" between the rights of taxpayers and the collection of taxes in this country. The principal statutes and regulations which govern the IRS' collection activities include:

- * The Internal Revenue Code of 1986
- * The Privacy Act of 1974
- * Internal Revenue Code; Sections 6103, 7213, and 7431
- * 18 U.S.C. 641 (Criminal penalties for conversion of government records)
- * 15 U.S.C. 1962; Fair Debt Collection Practices Act
- * Taxpayer Bill of Rights (1988); Public Law No. 100-647

The House of Representatives recently passed an enhanced "Taxpayer Bill of Rights" which includes thirty-two items which give taxpayers additional powers in any potential dispute with the IRS. Clearly, the fair treatment of taxpayers has been of paramount importance to Congress over the years. In order to maintain this "balance" between taxpayers' rights and the right of the federal government to collect its accounts receivables, the above cited statutes and regulations must also apply to any private contractors who may seek to perform tax collection activities on behalf of the federal government.

Private debt collectors have already begun to voice their opposition to some of the critical components of this balance. On April 25, 1996, Mr. Curtis Prins, Legislative Consultant for the American Collectors Association, testified before the Subcommittee on

Oversight, Ways and Means Committee, that the "payment of private collectors is an area that must be addressed. Under current law, contingency fees are not allowed. That should be changed so that collectors only get paid when they collect." Mr. Saul Moskowitz, a partner in the private law firm of Dean Blakey & Moskowitz, and a strong advocate for the use of private debt collectors to collect federal tax debt, stated in his testimony before the same Subcommittee that "probably the most important element in a PCA's [private collection agency's] ability to collect student loans where others have failed stems from its ability to provide substantial performance incentives to individual collectors."

Such a change would completely reverse one of the key components of Public Law No. 100-647; the Taxpayer Bill of Rights (1988). Ms. Cynthia Beerbower, Deputy Assistant Secretary for Tax Policy, U.S. Department of the Treasury stated that "the Administration believes that compensation for any private debt collection initiative should be subject to the same constraints as are imposed on the IRS. If such a contingent compensation arrangement is not allowable for our own employees, over whom we have [direct] supervisory control, why would we permit it for private contractors for whom the rights of citizens may not be the highest priority?"

Debt collection "production quotas" and contingency fees are also a major concern among members of the National Association of Enrolled Agents. Mr. Joseph Lane, an Enrolled Agent, stated on behalf of the National Association of Enrolled Agents, that "a major concern of NAEA members is the negative impact on taxpayers derived from turning over their cases to an industry noted for its heavy emphasis on production quotas." He went on to cite as an example a private debt collection company in Texas which keeps

a leather bomber jacket in a glass case in its lobby that gets awarded every month to the collection "Ace" who collects the most money per month. Mr. Lane then raised the question, "Is this really what we want to be broadcasting to taxpayers?"

Finally, the issue of taxpayer privacy must not be underestimated in its importance to individual taxpayers. Taxpayer privacy and the privacy of taxpayer information must be seriously considered as an important component of any decision to contract out the collection of tax debt in this country. A recent survey conducted by Anderson Consulting revealed that 59% of Americans oppose state tax agencies contracting with private companies to administer and collect taxes while only 35% favor such a proposal."

It is unclear to what extent private contractors value or understand the critical importance of a taxpayer's right to privacy. In both its oral and written testimony before the Subcommittee on Oversight, Committee on Ways and Means, the American Collectors Association, either underestimated, or intentionally attempted to downplay the critical importance of taxpayer privacy. Again, Mr. Curtis Prins, Legislative Consultant for ACA stated that, "one of the common misunderstandings about collection work, particularly if it is for the IRS, deals with privacy. Collectors don't want tax records. They simply want names, addresses, telephone numbers, amounts owed and employment information, if possible." In an oral statement submitted to the Subcommittee, Mr. Prins stated that "there has been unfounded fear that collectors will have access to tax records. That is not the case, nor is it the case when collectors work for state or local governments or even commercial concerns. The collector will be given the name of the individual or company that owes taxes and the amount, an address, phone number, if available, and place of employment. We won't get, and do not want, tax files or any other unimportant personal

information about a taxpayer." Nowhere in his written or oral testimony did Mr. Prins substantively address the issue of taxpayer privacy or the responsibilities of private collection agencies under the Privacy Act of 1974.¹) Today, taxpayers expect that all of the all of the information that is provided to the Internal Revenue Service will be kept confidential, especially income and salary levels, taxes paid, and the amount of tax due.

In defense of private debt collectors' access to confidential taxpayer information, Mr. Saul Moskowitz, a private attorney who cites his more than fifteen years of experience with the Department of Education's Student Loan program, both as an attorney for the Department of Education and currently in private practice, stated that the confidential financial information an individual must provide to ED [the Dept. of Education] in order to receive an FFELP loan often exceeds the information provided to the IRS on a taxpayer's Form 1040." Mr. Moskowitz apparently fails to make the significant distinction between information that is voluntarily provided as part of a student loan application and information that is mandated by the federal government as part of a federal tax return. While such a statement may be true, it completely ignores the terms under which such information is provided.

^{1.)} It is also of interest to note that in both statements before this Subcommittee, the American Collectors Association referenced their interest in receiving employment information. This is not information that is to be provided to private contractors under the current IRS Request for Proposals, nor is it information that is commonly provided to private tax debt collectors by states.

THE "UNIQUE" NATURE OF IRS ACCOUNTS RECEIVABLES:

Federal tax liabilities, including penalties and interest, are commonly referred to as "accounts receivables." The level of voluntary compliance with tax laws in the United States has remained relatively constant for the past decade. In 1995 voluntary compliance stood at 86%. The IRS has been working to develop a business plan to increase voluntary compliance levels to 90% by the end of the current decade. As Congress continues to focus increasing attention on efforts to balance the federal budget and decrease the deficit, the IRS accounts receivable inventory has come under increasingly greater scrutiny as a potential source of revenue which could be used for this purpose.

At the conclusion of FY '95, IRS' gross accounts receivable inventory totaled approximately \$200 billion. Of this total, \$143 billion represented taxes due to the IRS. The remaining \$57 billion consisted of accrued interest and penalties.

The IRS further divides its accounts receivable inventory into two primary categories: Currently Not Collectible (CNC), and Active Accounts Receivable (AAC). At the end of FY '95, \$87.4 billion was classified as CNC. Approximately 85% of this \$87.4 billion was owed by defunct corporations, bankrupt taxpayers, deceased taxpayers, or taxpayers that have been determined to have significant hardships. A small percentage of the CNC inventory consisted of taxpayers that the IRS has been unable to locate or contact.

On the other hand, at the end of FY '95, \$88.8 billion was classified by the IRS as "Active Accounts Receivables." Of this amount, \$36.6 billion had been assigned for enforcement action; \$19.1 billion was awaiting adjudication by the courts or acceptance

of an offer in compromise; \$11.7 billion is currently being collected through the notice process; \$11.2 billion is being collected through installment agreements; and \$1.6 billion represents lower value cases that will be collected through systemic monitoring such as refund offsets and yearly notices to taxpayers.

When the American Collectors Association (ACA) argues its case, it is quick to point to the IRS' alleged \$200 billion in accounts receivables as justification for its involvement in the collection of federal tax debt. What ACA fails to point out is that in the private sector approximately 80% of this alleged \$200 billion would have been written off as "uncollectible" long ago.

In addition, the majority of the accounts which currently make up the IRS accounts receivable inventory do not appear "to fit the profile" of the types of cases that private collectors want to contract with the IRS to collect. Mr. Philip Rosenthal, Chairman of the American Collectors Association's National Legislative Council stated that "the [IRS] test program is made up of collection cases which are anything but the type that would fit the profile of a private sector collection agency. Of the cases in the business queue that are currently being offered under contract to private collectors as part of the IRS pilot program, 91% are over three years old and 52% are greater than six years old. In the individual queue, 77% are more than three years old and 28% are greater than six years old. In every category, cases less than one year old represent the smallest percentages." Although Mr. Rosenthal may be correct in his statement that such cases are anything but typical of the types of cases that fit the profile of private sector collection agencies, these are typical profiles of the types of cases that are currently in the IRS accounts receivable inventory that has generated so much interest from private sector collection agencies.

It may be that by their own admission, private collection agencies are not well suited to collect on the typical profile of cases that currently make up the IRS accounts receivable inventory.

Of all of the issues being discussed concerning the most effective methods of collecting federal tax debts in this country, public and private sector debt collectors agree that the earlier a debtor receives a request for payment, the greater the likelihood that such a debt will be collected. That is why private debt collectors do not want to work cases that are more than one year old. Private collectors want to work on the collection of federal tax debt that is approximately 180 days old. In the same testimony referenced earlier, the ACA's proposed solution to the IRS accounts receivable inventory is that "when an IRS tax delinquency reaches 180 days, it should be turned over to the Financial Management Service of the Treasury Department. FMS, which has broad experience with private contractors will then turn those accounts over to private collection agencies (PCA's)." In other words, private collectors want to work those cases that are the easiest to collect! This would leave older, more difficult cases, (allegedly the profile of cases which have been unfairly offered to private collection agencies during the current IRS test), for IRS collection employees to work. Clearly, agreeing to contract out the collection of accounts receivable cases that are only 180 days old would only expose the IRS to greater criticism as its average cost of collections increased and its effective rate of collection decreased.

Furthermore, it appears that, on average, private collection agencies may not be effective in the collection of such debt. Referencing its own study, ACA stated that "on accounts placed for collection within 30 days of delinquency, the average recovery rate

is 53%. After 90 days, the rate drops to 29%. After one year, the [collection] rate falls to 10%. When an account is placed after 421 days of delinquency, the collection rate is only 4%."

GAO's survey of states which have used private collectors tends to support such a notion. GAO found that "although many states, including 33 of the 43 states that responded to its survey, have used private collectors, their experiences have varied widely." Later in the same context, GAO stated that "using these states experiences as an indicator, IRS could expect some additional collections from its proposed pilot, but not necessarily a significant windfall."

One of the most fundamental differences between the collection of tax debt and non-tax debt is the point at which such a debt is actually established and becomes due. In the private sector, a liability is established voluntarily when goods or services are purchased or when a lender approves a voluntary application for debt. Upon the approval of such an application, or upon the purchase of such goods or services, the debtor voluntarily agrees to pay such a debt, in full, at the time of the transaction or over a period of time through installments. If a debtor who has entered into a voluntary agreement to pay such a debt defaults on such an agreement, the collection process begins immediately subject to the terms and conditions of the installment agreement and the law.

Tax liabilities and the collection of such liabilities is dramatically different. Tax liabilities are <u>not</u> established voluntarily. The IRS establishes a great deal of its accounts receivable inventory through the audit process. Taxpayers who disagree with the results of such an audit and the tax liabilities assessed, may exercise their rights through the administrative appeals process and pursue litigation. As a result, several years may pass

between the time a tax return is filed or due and the time that the tax liability (account receivable) is finally legally established. Such a time lapse, in conjunction with the involuntary nature of tax liabilities, makes the collection of tax debt distinctive from the collection of non-tax debt.

Mr. Gerald H. Goldberg, Executive Officer of the California Franchise Tax Board, reported similar conclusions based upon the State of California's experience with the use of private debt collectors. Mr. Goldberg stated that "the collection of tax debt is different from the collection of much commercial debt in that the debtor often has questions about the underlying legitimacy of the debt. This is true even thought the debtor has had previous notices and has not chosen to exercise his [or her] administrative protest and appeal rights before the debt became final. Taxpayers frequently feel that they do not owe the debt. In other cases they may question the legitimacy of penalty or interest calculations. Or they may assert that the debt was paid, but credited to the wrong year or the wrong account." Under the California private debt collection program, if a taxpayer or debtor raises a question regarding the legitimacy of his or her outstanding liability, private collectors are not allowed to take any further action to collect on such a case. Such cases are simply referred back to the California Franchise Tax Board for further action.

Of the cases referred to private collectors, the State of California reports that it receives payments in full from approximately 10% of the cases it refers. In other cases partial payments are received or the debt is simply written off as uncollectible. Such an experience tends to support GAO's statement that "using these states' experience as an indicator, IRS could expect some additional collections from its proposed pilot, but not

necessarily a significant windfall."

CONCLUSIONS TO BE DRAWN:

NTEU adamantly opposes the use of private debt collectors to collect federal tax debt in this country. Clearly, it is no mystery that private debt collectors view the collection of federal tax debt as a potential source of new profits. In their testimony before the Subcommittee it was clear that they want to work the most recent cases, (less than 180 days old), on a contingency fee basis which is currently prohibited by statute. This dream of easy cases and big contingency fees is also the dream of many Revenue Officers and other IRS collection employees! But it is only a dream. Our tax system, which depends upon good faith and the voluntary compliance of our citizens, would not function as effectively as it currently functions if such a dream were allowed to become a reality. If we are to continue to maintain the delicate balance between taxpayers' rights and the federal government's right and responsibility to collect taxes, including delinquent tax debt, Congress must refrain from contracting out the collection of such debt to private contractors motivated by profit.

Instead, Congress must focus its attention on the needs of IRS collection employees. These employees want to do the best job that they can. When properly funded and equipped with up-to-date technology, IRS collection employees can increase their efficiency and effectiveness and decrease this country's accounts receivable inventory. The success of the FY '95 Compliance Initiative proved this fact. There are other examples as well. The IRS Integrated Collection System, (ICS), which is currently

operational in two IRS districts and is currently being installed in six (6) additional district offices this fiscal year, has increased the dollars collected by Revenue Officers in these districts by thirty (30%) percent. With this new technology, these employees are working more cases, closing them faster, and collecting more dollars than ever before. These are the types of programs that Congress must continue to support and provide adequate funding for in the future in order to increase the rate of federal tax debt collection.

NTEU would suggest that if this Subcommittee continues to pursue the use of private contractors to perform collection-related activities, it would be well served to also look to the seven (7) state agencies that have had private debt collection programs in the past and have dropped them. We would also recommend that the Subcommittee refer back to the numerous hearings which were held several years ago by former Chairman of the House Subcommittee on Oversight, Government Operations Committee, Congressman Doug Barnard, which thoroughly investigated and brought to an end the practice of evaluating IRS collection employees based on the amount of revenue collected.

STATEMENT OF UNITED CREDITOR ALLIANCE CORP.

I. INTRODUCTION

United Creditor Alliance Corporation ("UCA") is pleased to submit this written statement for the record for the April 25, 1996 hearing on Tax Debt Collection Issues before the Subcommittee on Oversight, House Committee on Ways and Means.

UCA strongly supports efforts to privatize certain collection activities relating to appropriate IRS outstanding tax debt and looks forward to working with the Subcommittee on this important initiative.

II. BACKGROUND

UCA is a division of the National Revenue Corporation, which out of over 6,000 collection agencies is the 4th largest in the country. The National Revenue Corporation is a subsidiary of Deluxe Corporation, a large New York Stock Exchange Company. The National Revenue Corporation is a pioneer in the industry and was a winning bidder on a U.S. Department of Treasury collection contract in the early 1980's. Its division, UCA, recently won a contract to collect state taxes in Ohio, and has contracts with other states and municipalities.

UCA is a national credit collection agency that has extensive expertise in a wide variety of collection activities gained from many years of handling millions of government, health care, retail consumer and commercial collection accounts. UCA has located and contacted hundreds of thousands of individuals and resolved hundreds of millions of dollars worth of outstanding debt. UCA's acquisition of key experienced management and line collection personnel as well as its expansion of other resources in the last several years has yielded a corporate clientele that includes many major U.S. companies including, American Express, Bank of America, Sprint Communications, Ameritech, Citicorp and AT&T Universal Card Services.

UCA subscribes to the highest ethical standards and recognizes the basic dignity of each debtor. UCA has developed Quality Programs and Incentive Programs that ensure a high degree of professionalism, minimize employee turnover and create an atmosphere of teamwork.

UCA has an open-minded approach to individual client accounts and prides itself on its capacity to specifically tailor its programs for each client's situation while at the same time maintaining its ability to manage, direct and control large scale collection projects.

UCA has developed a system of team management that enables it to respond quickly to the needs of its clients and has developed techniques and implemented methodologies which have resulted in collection recoveries that are among the highest in the industry. UCA has pioneered the development of non-alienating collection techniques because this helps improve collection success and also because such techniques support the debtors dignity and retain the goodwill necessary for continued success.

UCA believes that the knowledge, experience and expertise gained over the years by UCA and other private collection firms in the debt collection area can be applied to IRS debt collection activities in a manner which will increase Federal revenues, while maintaining the safeguards and protections expected of our Federal tax collection system.

III. ISSUES RELATED TO THE PRIVATIZATION OF TAX COLLECTIONS

The Department of Treasury and the Internal Revenue Service have expressed several concerns relating to the privatization of tax debt collection services. These concerns focus on taxpayers' rights; the danger of disclosure of taxpayers confidential

information; and, the delegation of functions that are inherently governmental in nature. UCA shares the concerns registered by the Department of Treasury and the IRS and offers the following comments:

A. Respect of taxpayers' rights. UCA has invested a great deal of energy and man-hours in developing non-confrontational collection methods that are premised on the utmost respect for the basic dignity of the debtor. In addition to the statutory bars to certain collection methods, UCA recognizes that without the cooperation of the debtor, most collection attempts will be in vain. Typically, UCA will trace debtors to update information relating to current addresses and employers and spend time with the debtor to make the debtor aware of the debt, its amount, payment options and any reporting requirements. UCA employees endeavor to offer these services with a customer service mentality so that the debtor will remain as comfortable as possible while dealing with our professionals. Any failure on the part of UCA personnel to maintain this demeanor in dealing with debtors will only result in the ultimate disservice to our clients.

As applied to the collection of IRS tax debt, UCA supports the application of all provisions of the law governing taxpayer rights to private collection firms. In addition, UCA supports the application to private collection firms of all the provisions of the "Taxpayer Bill of Rights 2," a bill which recently passed the House of Representatives. Application of these rules of law to both the IRS and private collection firms will ensure that taxpayers are fairly treated throughout the collection process.

B. Disclosure of taxpayers' confidential information.

Depending on the structure of the collection contract with a client, UCA has as much or as little access to debtors files as its clients desire. In many cases, UCA simply provides tracing

and contact services for clients so that the only information to which UCA personnel have access is rudimentary information, such as the debtor's name, last known address, telephone number, employment information and the amount owed.

UCA believes control over IRS tax records or other sensitive information should remain in the control of the IRS. As stated above, UCA fully supports the application of all laws governing taxpayers rights to private collection firms.

C. Delegation of inherent government functions. The Department of Treasury and the Internal Revenue Service have both registered concerns relating to the delegation of inherent government functions.

UCA believes that many of these concerns can be addressed in the contracting process. No power should be delegated to a private collector that the government would not want delegated. If Congress and the federal government ultimately determine that implementation of private collection contracts is in the best interest of the country, then the rules and guidelines governing the underlying service contracts with any debt collection firm can appropriately incorporate the powers and techniques that should be delegated. If a private collection company was not granted the authority under a contract to compromise tax debt for less than full value or to seize property on behalf of a client before a judgment confirming debt, then this practice would not There would be no economic incentive for a take place. collection agency to implement these techniques, especially a collection agency for the federal government, if the success of the collection would be compromised by illicit collection activities. It is simply not worth jeopardizing a contract to act beyond the scope of activities allowed by that contract.

There are many collection services that are deemed permissible by the Department of Treasury and the IRS and that could be incorporated in a contract with a private collection firm. These permissible services include permitting a private collection firm to trace and recover delinquent taxes. According to the Department of Treasury and the IRS, a private collection firm could provide locator services; mail notices of debt due and include information on the amount owed and payment options; contact debtors by telephone to remind them of their debt; secure intentions to repay on the part of debtors; provide lock box services for receipt and processing of payments; provide data processing performed in connection with tax collection; provide research and data gathering services; and provide financial audits of support services. All done through a contracting process which will govern the scope of private collection firm activity.

UCA supports the ability of the IRS to contract out the above described activities. Other permissible activities may also be appropriate and could be reviewed as part of the privatization initiative.

Concern has also been raised over the types of debt which should be initially subject to a privatization effort. UCA believes that a reasonable approach should be taken and supports the use of private collection activities for IRS "Deferred Accounts" (those that the IRS does not pursue because they fall below an IRS-established threshold), and certain "Currently Non-Collectible" ("CNC") accounts.

UCA does not believe it would be efficient or in the best interest of the government or taxpayers to pursue at this time accounts which the IRS has already reviewed and deemed inappropriate to pursue. UCA, therefore, does not believe "CNC-

Hardship" cases should be initially subject to privatization efforts.

D. Payment for services. UCA has noted that there is concern over the ability of the federal government to structure payments under collection contracts on the basis of the amount collected. There has also been general concern raised in the wisdom of allowing this type of payment structure. UCA appreciates the concern that any payment structure based on the amount collected could ultimately lead a collection agency to use overly aggressive collection methods. But at the same time, the government must evaluate the overall effectiveness and efficiency of the system that it wishes to create.

Any payment system that does not place a premium on collections will not work to the advantage of the government. The simple fact of the matter is that if a company receives a flat fee for collections, the incentive to consistently improve and refine its collection methods does not exist. The government must place confidence in the fact that the types of collection methods can be regulated by law and under the contract with a private collection agency. So regulated, those methods will be respected. Any collection company that acts contrary to these mandates will lose its contract and suffer any other consequences proscribed by law. This is more than enough incentive to work within the collection parameters demanded by the government.

To the extent that this type of payment arrangement is prohibited under the Prompt Deposit Act¹ or section 7809 of the Internal Revenue Code, the Congress should consider revisiting these statutes to make sure that the system that they propose to create has the opportunity to function properly.

^{1 31} U.S.C. §3302.

UCA believes that a payment system involving premiums and other incentives can be established in a manner to ensure taxpayer rights and government protections. UCA believes this type of system is the most efficient and beneficial for both the government and the private collection firms and urges the Subcommittee to consider this form of payment for services in more detail.

IV. CONCLUSION

UCA looks forward to working with the Committee, Congress and the Department of Treasury in constructing a private collection system for IRS outstanding tax debt that works to the advantage of all parties in the system.

We thank the Committee for the opportunity to submit this written statement for the record.

WATKINS, MEEGAN, DRURY & COMPANY, L.L.C.

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April 24, 1996

Phillip D. Mosely, Chief of Staff Committee on Ways and Means U.S. House of Representatives 1102 Longworth House Office Building Washington, DC 20515

Re: Hearing on Tax Debt Collection

Dear Mr. Mosely:

During the upcoming hearings to be held by the subcommittee concerning the management of the Internal Revenue Service accounts receivable inventory and the effectiveness of measures put into place over the past several years to improve the Service's management of the inventory, we would propose that the subcommittee also look at the possibility of offering a federal tax ammesty program.

Numerous states and local governments have offered such programs in the past and one state currently has such a program in place. Several states have even offered amnesty programs more than once. To our knowledge, not one of these states has suffered a loss of tax revenue because of the program, and, in fact, the states have placed taxpayers on the tax rolls who had not been paying their share of taxes in the past.

We have been to numerous meetings and seminars where representatives of the Service have spoken about this issue. The thrust of their comments is that it would not be fair to the majority of taxpayers who are paying their taxes. The Service seems to be quite proud of the fact that they have budgeted more than \$100 million to the area of finding and collecting taxes from non-filers. The subcommittee is meeting to discuss the use of private collection agencies to collect delinquent federal taxes. Again more funds would be expended for delinquent taxpayers and unpaid taxes.

Phillip D. Mosely, Chief of Staff Committee on Ways and Means U.S. House of Representatives April 24, 1996

There are several reasons why taxes are not paid nor returns filed, not all of which have a criminal intent. We have obtained numerous clients who stopped filing because of a sudden health crisis, loss of records due to natural disasters, and just fear of not being able to pay the tax due and then being prosecuted for this failure. Many times an event causes the taxpayer to miss filing for one year and out of fear, ignorance, or other reasons, they continue with this non-filing pattern. Many of these people feel a real sense of relief when they finally deal with the issue and file returns that are past due.

We would suggest that it is unfair to the majority of taxpaying citizens to continue spending millions of dollars to collect past due taxes as opposed to taking a step that many states have taken to get people back on the tax rolls. If a federal ammesty program were put into place for six months, we believe that many of the delinquent taxpayers would come forward and file delinquent returns and pay the back taxes. More importantly, they would be back on the tax rolls and would pay taxes in the future. The cost of such a program would be the abatement of penalties that in many cases would be eliminated or negotiated through an offer in compromise or bankruptcy proceeding. The time has come to address this issue realistically and not let the Service's statements dictate how the law abiding taxpayer feels about the issue of a federal ammesty program.

The thrust of the subcommittee hearings could then be focused on how to prosecute those taxpayers who do not take advantage of this program. Many states deal with this issue and it would serve the public if it were addressed at the national level in a forum that serves the public.

Very truly yours,

WATKINS, MEEGAN, DRURY & COMPANY, L.L.C.

James C. Wagenmann

JCW/pf

WATKINS, MEEGAN, DRURY & COMPANY, L.L.C., CERTIFIED PUBLIC ACCOUNTANTS



EMPLOYMENT CLASSIFICATION ISSUES

HEARINGS

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT OF THE

COMMITTEE ON WAYS AND MEANS HOUSE OF REPRESENTATIVES

ONE HUNDRED FOURTH CONGRESS

SECOND SESSION

JUNE 4 AND 20, 1996

Serial 104-84

Printed for the use of the Committee on Ways and Means



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EMPLOYMENT CLASSIFICATION ISSUES

TUESDAY, JUNE 4, 1996

House of Representatives, Committee on Ways and Means, Subcommittee on Oversight, Washington, DC.

The Subcommittee met, pursuant to call, at 9:35 a.m., in room 1100, Longworth House Office Building, Hon. Nancy L. Johnson (Chairman of the Subcommittee) presiding.
[The advisories announcing the hearings follow:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

SUBCOMMITTEE ON OVERSIGHT

FOR IMMEDIATE RELEASE May 23, 1996 No. OV-13 CONTACT: (202)-225-7601

Johnson Announces Hearing on Employment Classification Issues

Congresswoman Nancy L. Johnson (R-CT), Chairman of the Subcommittee on Oversight of the Committee on Ways and Means, today announced that the Subcommittee will hold a hearing to examine current issues relating to the classification of workers as employees or independent contractors for Federal tax purposes. The hearing will take place on Tuesday, June 4, 1996, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 9:30 a.m.

In view of the limited time available to hear witnesses, oral testimony at this hearing will be heard from invited witnesses only. Planned witnesses include officials from the Department of the Treasury and Internal Revenue Service (IRS), numerous small business owners, tax practitioners, and representatives from organized labor. Any individual or organization not scheduled for an oral appearance may submit a written statement for consideration by the Committee and for inclusion in the printed record of the hearing.

BACKGROUND:

The classification of workers as either employees or independent contractors for Federal tax purposes generally is determined under common law (i.e., nonstatutory) rules. Under the common law, if a person engaging the services of another has "the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work, but also as to the details and means by which that result is accomplished," then the relationship of employer and employee exists.

Employment classification issues have long been the subject of considerable controversy between taxpayers and the IRS. In the late 1960s, the IRS significantly increased its employment tax audit activities. In cases when the IRS prevailed in reclassifying workers from independent contractors to employees under the common-law test, the employing business could be assessed significant amounts for Social Security and Medicare taxes (Federal Insurance Contributions Act or "FICA") and Federal Unemployment Tax Act (FUTA) taxes on behalf of the reclassified employees, even though the employees might have fully paid their liabilities for self-employment and income taxes. In many cases, the back-tax liabilities assessed were so large that the companies were forced into bankruptcy.

In response to this problem, Congress enacted section 530 of the Revenue Act of 1978 (P.L. 95-600). This provision generally allows a taxpayer to treat a worker as an independent contractor for employment tax purposes, regardless of the actual status under the common-law test, unless the taxpayer has no reasonable basis for such treatment. Under section 530, a taxpayer is relieved from Federal employment tax liability when it can demonstrate that, in classifying its workers as independent contractors, it reasonably relied upon: (1) a past IRS audit of the taxpayer; (2) published rulings, a private letter ruling, or judicial precedents; (3) a long-standing recognized practice of a significant segment of the taxpayer's industry; or (4) any other reasonable basis.

The section 530 safe harbor was intended to alleviate what the Congress perceived as overly zealous pursuit and assessment of taxes and penalties by the IRS against employers who had, in good faith, misclassified their employees as independent contractors. The legislative history of this provision indicates that the Congress intended for the section 530 safe harbor relief to be liberally construed and applied by the IRS.

In recent years, the IRS has again stepped up its enforcement efforts with regard to employment tax issues, particularly with regard to small businesses with assets of \$3 million or less. The IRS has focused its enforcement resources in this area because its data suggests that such small businesses are the most likely to misclassify the status of workers.

However, many small businesses undergoing employment tax audits do not have the financial resources necessary to litigate adverse determinations by the IRS, even where the IRS's determination was erroneous. Moreover, those who do appeal IRS efforts to reclassify their workers and successfully prevail in litigation may incur hundreds of thousands of dollars in administrative costs, accountant and attorney fees during the examination and administrative appeals phase which may not be fully recovered. Although Internal Revenue Code section 7430 provides for the payment of attorney fees and certain costs by the Federal Government when taxpayers substantially prevail on the merits of their tax disputes with the IRS and the IRS's position was not substantially justified, this provision only applies to litigation costs incurred in connection with a court proceeding.

At last year's White House Conference on Small Business, a legislative solution to the problem of the IRS's aggressiveness in recharacterizing independent contractors as employees was ranked the number one priority among small businesses. Although the Administration has no legislative proposal to address this issue, the IRS has several administrative initiatives underway which attempt to address small businesses' concerns about the IRS's handling of worker classification issues.

First, the IRS has developed a new classification settlement program which will be available for a two-year test period. Under this program, an optional standard settlement agreement will be offered to businesses which filed Form 1099 information returns, but failed to meet all other requirements for relief under section 530. The settlement agreement will require workers to be reclassified prospectively as employees and the taxpayer will pay an assessment not to exceed one year's liability. Second, the IRS has developed a new procedure to allow businesses, at their option, to appeal employment tax issues to the IRS Appeals Office while the examination is still in progress in order to allow quicker resolution of the worker classification issue. Finally, the IRS issued for public comment a draft of new training materials for IRS examiners who handle worker classification issues (comment period closed April 28, 1996), and will examine comments before instituting the training.

Several bills have been introduced in this session of Congress to clarify the rules for classifying workers for Federal tax purposes, including H.R. 1972, the "Independent Contractor Tax Simplification Act of 1996," introduced by Representative Jon Christensen, and H.R. 582, the "Independent Contractor Tax Fairness Act of 1995," introduced by Representative Jay Kim.

In announcing the hearing, Subcommittee Chairman Nancy L. Johnson stated, "Although I am very encouraged by the IRS's worker classification initiatives and Commissioner Richardson's statements that this issue is one of the IRS's top concerns, I question whether these steps alone will be adequate to bring long-needed certainty to this area. I believe the Subcommittee needs to have a complete airing of this issue and to consider legislative proposals to clarify the classification of workers for Federal tax purposes."

FOCUS OF THE HEARING:

The Subcommittee will examine current problems with regard to classification of workers for tax purposes, including the IRS's handling of employment tax audit issues and reasons for its failure to liberally construe and administer the safe harbor rules created by section 530 of the Revenue Act of 1978. The Subcommittee will also consider whether the IRS's recent worker classification initiatives (i.e., the settlement program, revised training materials, and appeals policy changes) will adequately address perceived problems in this area. In addition, the Subcommittee will receive testimony on proposed legislation to clarify the tax laws relating to worker classification (e.g., H.R. 1972 and H.R. 582).

The Subcommittee will also examine whether modifications to the section 530 safe harbor rules are desirable. For example, should the section 530 safe harbor be modified to apply for income tax purposes as well as employment tax purposes? Is a statutory clarification of what constitutes a "significant segment" of the taxpayer's industry desirable? Finally, the Subcommittee will also examine independent contractor tax compliance and whether changes to improve compliance (e.g., expanded information reporting requirements or increases in penalties for failure to file Forms 1099) are desirable.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Any person or organization wishing to submit a written statement for the printed record of the hearing should submit at least six (6) legal size copies of their statement, with their address and date of hearing noted, by the close of business, Tuesday, June 18, 1996, to Phillip D. Moseley, Chief of Staff, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements wish to have their statements distributed to the press and interested public at the hearing, they may deliver 200 additional copies for this purpose to the Subcommittee on Oversight office, room 1136 Longworth House Office Building, at least one hour before the hearing begins.

FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

- All statements and any accompanying exhibits for printing must be typed in single space on legal-size paper and may not
 exceed a total of 10 pages including attachments.
- Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should
 be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files
 for review and use by the Committee.
- 3. A witness appearing at a public hearing, or submitting a statement for the record of a public hearing, or submitting written comments in response to a published request for comments by the Committee, must include on his statement or submission a list of all clients, persons, or organizations on whose behalf the witness appears.
- 4. A supplemental sheet must accompany each statement listing the name, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. This supplements better with one included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press and the public during the course of a public hearing may be submitted in other forms.

Note: All Committee advisories and news releases are now available over the Internet at GOPHER.HOUSE.GOV, under 'HOUSE COMMITTEE INFORMATION'.

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

SUBCOMMITTEE ON OVERSIGHT

FOR IMMEDIATE RELEASE June 13, 1996 No. OV-14 CONTACT: (202) 225-7601

Johnson Announces Second Day of Hearings on Employment Classification Issues

Congresswoman Nancy L. Johnson (R-CT), Chairman of the Subcommittee on Oversight of the Committee on Ways and Means, today announced that the Subcommittee will hold a second day of hearings to examine current issues relating to the classification of workers as employees or independent contractors for Federal tax purposes. The hearing will take place on Thursday, June 20, 1996, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 10:00 a.m. The first day of hearings took place on June 4, 1996. (See Subcommittee press release No. OS-13, dated May 23, 1996.)

Oral testimony at this hearing will be heard from invited witnesses only. Planned witnesses include officials from the U.S. Department of the Treasury and Internal Revenue Service, the General Accounting Office, tax practitioners and others. Any individual or organization not scheduled for an oral appearance may submit a written statement for consideration by the Committee and for inclusion in the printed record of the hearing.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Any person or organization wishing to submit a written statement for the printed record of the hearing should submit at least six (6) legal size copies of their statement, with their address and date of hearing noted, by the close of business, Monday, July 8, 1996, to Phillip D. Moseley, Chief of Staff, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements wish to have their statements distributed to the press and interested public at the hearing, they may deliver 200 additional copies for this purpose to the Subcommittee on Oversight office, room 1136 Longworth House Office Building, at least one hour before the hearing begins.

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- 4. A supplemental sheet must accompany each statement listing the name, full address, a telephone number where the witness or the designated representative may be reached and a topical outlier or summary of the comments and recommendations in the full statement. This supplemental sheet will not be included in the printed record.

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Note: All Committee advisories and news releases are now available over the Internet at GOPHER.HOUSE.GOV, under 'HOUSE COMMITTEE INFORMATION'.

Chairman JOHNSON. Good morning, everyone. It is a pleasure to have you here this morning.

Welcome to Senator Gramm. Nice to have you on this side. And to my colleagues, Hon. Jon Christensen, and Hon. Jay Kim. Thank

you for being with us.

Today the Oversight Subcommittee is going to wander into wild woods where even angels fear to tread, the classification of workers as employees or independent contractors for Federal tax purposes. As you know, the issue has had a long and controversial history, and is one of the major sources of friction between the Internal Revenue Service and taxpayers, particularly small businessmen.

At last year's White House Conference on Small Business, a legislative solution to the problem of the IRS' aggressiveness in recharacterizing individual contractors as employees was ranked the number one concern among small businesses. The determination of whether workers and employees are independent contractors is made under a common law test which looks at whether the person engaging the services of another has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work, but also as to the details and means by which the result is accomplished.

While this may sound simple, the common law test is anything but simple. Most employment relationships possess elements of both an employer-employee relationship and an employer-independent contractor relationship, and there isn't any bright yellow line

which distinguishes the two.

As a result of ambiguity and conflicting interpretations under the common law test, reasonable people have often reached different conclusions as to the proper classification of a worker. Unfortunately, the consequences of even a good-faith mistake about the proper classification of workers for tax purposes can have devastat-

ing consequences for small businesses.

In cases where the IRS determines that a company has misclassified its workers as independent contractors, the employer can be assessed significant amounts of Social Security, Medicare and Federal unemployment taxes on behalf of the reclassified employees, even though the employees may have fully paid their liabilities for self-employment and income taxes. In some cases, the back tax liabilities assessed are so large that the companies are forced into bankruptcy.

Further, IRS agents have been known to privately acknowledge the protection offered by section 530 "safe harbor" provisions, but refuse to concede this issue to force a small business that cannot afford to appeal or pay back taxes to prospectively reclassify employees as independent contractors to satisfy the IRS agent. This is abusive, this is blackmail, and this is the kind of thing that poor law allows.

The time to solve this problem is at hand. The process starts today, to identify clear, fair, objective standards to prevent the IRS from abusing taxpayers, while assuring fair share compliance.

Several bills have been introduced in this session to clarify the rules for classifying workers for Federal tax purposes. I am pleased

today we will hear from the authors of several of those.

The Subcommittee will hear from several small businesses regarding their experience with the IRS and from a representative with organized labor. Unfortunately, Bob Georgine, president of the Building and Construction Trades Department of the AFL-CIO, who had been scheduled to testify, will not be able to attend because of scheduling changes in today's hearings. He will be represented by written statement and will be heard at later panels.

This is the first of two hearings to examine this issue. On June 20, the Subcommittee will receive testimony from the Treasury, IRS, GAO, taxpayers, and others about whether or not the IRS' recent worker reclassification initiatives are sufficient to address the problems in this area or whether a legislative solution is necessary.

The Subcommittee will also examine whether modifications to the "safe harbor" created by section 530 of the Revenue Act of 1978 rules are desirable. The Subcommittee is going to take a hard look at independent contractor tax compliance and move to fix the

problems in this area.

It is my belief that examination will lead to the development of a bipartisan consensus, on actions that can be taken to help clarify this longstanding problem in tax law. At this time when our Nation's economic growth depends on the growth in the small business and medium-sized business sector, it is imperative to support and encourage that growth in every way possible. Clarifying this passage of tax law is one important step we can and must take.

It is my privilege to recognize this morning, first, my colleague, Mr. Matsui, from California, whom I appreciate very much having made the effort to be here today, even though we do not have floor votes, and I would like to welcome my colleague, Representative Greg Laughlin, also, and thank him for being here today on a day when we actually are not going to have to vote.

Mr. Matsui.

Mr. MATSUI. Thank you very much, Chairman Johnson. I want to thank you and commend you for holding these very important hearings, and certainly I commend my colleague Mr. Laughlin for being here as well, given the fact that we do not have any votes

todav.

To the three gentlemen, Senator Gramm from Texas, Congressman Kim from my home State, and Congressman Christensen from the State of Nebraska, I am going to be very brief in my comments. I think, as Madam Chairman has said, there will be another series of hearings on the June 20, and it would be my hope that individuals will suspend judgment on this issue until they hear from the Treasury Department, the Internal Revenue Service, GAO, and certainly tax practitioners—those particularly in the New York State bar, because they might have a different set of facts, different set of circumstances, and different conclusions drawn from what is going on in terms of the issue of independent contractors.

It is my belief that Representative Johnson and the Members on her side of the aisle and those on our side will probably be able to come up with something bipartisan. Mrs. Johnson and I have worked very closely together over the last year and a half, and we have been able to come up with a number of bipartisan pieces of legislation that passed the House unanimously or close to it. We

will certainly try in this particular case, as well.

I remember, as a law student, one of the big issues—I do not know if they teach agency courses any longer in law schools, but when I was going to law school, they taught agency courses. The issue of independent contractors or the employment relationship is a very important relationship. In the cases that I used to read in the late sixties, the issue was whether or not the employee, when he or she committed a tort or the employer was responsible.

Now we have a whole different set of circumstances. That issue no longer, in terms of tort responsibility, is a key one. The key issues today are benefits—pension benefits, health care benefits,

benefits that employers often give to employees.

The reason this issue has taken on a life of its own and has become so critical over the last 20-plus years, or so is mainly because of nondiscrimination rules to a large extent. Employers in the past were not required to provide the same benefits to employees as they gave to management or to themselves with the non-discrimination rules. That has all changed, so many employers are trying to find ways in which they can make employees independent contractors.

Certainly we need a balance. We need to make sure that the rights of the employer are protected, but we also need to make sure that the rights of the employees are protected, because as I indicated, that employment relationship has certain very valuable benefits to it, particularly health care benefits and pension benefits, which I think everyone understands is the cause of a great deal of security in America today.

It would be my hope that this debate does not turn into the debate of extremism that we have seen in the past. It is my hope we are going to be able to deal with this issue in a very rational fashion and make sure that both sides are reasonably protected, but particularly the employee side of the equation is protected.

Let me just conclude by making one further observation. As you know, the Internal Revenue Service, Treasury Department, has a test of 20 different criteria they use at this time. It is cumbersome.

On the other hand, this relationship has developed over a long period of common law in England and certainly the 230-year history of our country in terms of the court decisions. It would be my hope we are not precipitous in passing legislation. The gentlemen before us have different kinds of tests, and we will analyze those tests and see if in fact they work, see if in fact they do damage or help the employment relationship.

So, I look forward to working with the Chair and certainly other

Members that are interested in this issue. Thank you.

Chairman JOHNSON. Thank you, Bob.

Representative Laughlin.

Mr. LAUGHLIN. Thank you, Madam Chairman. I thank you very

much for calling this hearing.

Certainly we are delving into a murky area that has imposed extreme hardship on the independent contractor and particularly the small business independent contractor. I am hopeful that these hearings will focus on what is best for the small business owner, the small business protector, who is providing jobs in many instances when the very large corporations who have followed the

mandates of government in many areas are laying off thousands of

people.

I hope that we look at what is best for those who are picking up the pace, employing those laid-off workers and give a well-informed process to that business operator who is providing much-needed jobs for our economy.

Chairman JOHNSON. Thank you.

Welcome, Senator Gramm. It is a pleasure to hear from you at this time.

STATEMENT OF HON. PHIL GRAMM, A U.S. SENATOR FROM THE STATE OF TEXAS

Senator GRAMM. Madam Chairman, first of all, let me say I am very happy to be here today. I think you are going to hear a lot about independent contractors today, so I will be brief on that

general subject.

I think we have a problem with the 20-rule guideline of IRS, and that the logical way to fix it is to say, by law, who is not an employee. I think we ought to go at it from that direction. This is what we tried to do in the Senate. I think it is very important and I think we ought to be very concerned about anything that endangers independent contractors.

Independent contracting is basically an incubator for small business. A lot of people begin as independent contractors to sort of test their wings in the marketplace, so to speak. Many of our most successful companies, paying the highest wages, providing the best benefits, have ultimately come from people who started out on their

own as independent contractors.

I think it is important that we look at independent contracting not just as a method of business organization, but as a stepping stone toward the establishment of successful small, medium-sized, and ultimately big businesses.

I wanted to concentrate today on one little facet of this problem, and that problem has to do with newspapers and with what we call

the "paper boy."

Now, I tried this morning, to think of alternatives that would not carry the sexual connotation, because I am positive that there are paper girls, but the term just simply is not one that rings in our ears. So, if I can be forgiven by the Chairman, I will just, use the term "paper boy."

I wanted to explain why this form of independent contracting is so vitally important for America. Forget the newspapers, but lets

focus in on just paper boys.

When I was in academics, I got off into an area of economic history, and one of the things I discovered was that miraculously in the 19th, 18th, and the 17th centuries, educated people understood the economy and how it worked a lot better than educated people do today. I started racking my brain about how that could be so. And the conclusion I came to was that in the specialized world we live in, being in economic life for most people does not teach you much about the economy.

Most people go to work for a business, they specialize in, say, buying things for the business, but they do not engage in selling things. Or people engage in the production of something, but they

do not engage in the purchasing of the inputs or selling the final product.

It is very seldom in our life in the specialized world we live in that actually living and functioning in our society becomes an educational institution teach us how our great economy works, how prices are determined, and how markets work.

Interestingly enough, the entry level job for literally millions of young people in America is becoming paper boys, it is one job where—at a very early age—people have an opportunity to in

essence be in business for themselves.

When I was a paper boy in Columbus, Georgia, I threw the Columbus Ledger-Enquirer. I threw 105 newspapers, which I purchased weekly from the newspaper. I threw the newspaper and then I collected money from the 105 people—well, the ones who actually paid me. And what I earned was the difference between the two. I was, in the language of your debate, an independent contractor.

But the important thing is that as a paper boy, it gave me an insight into how our free enterprise system worked. It was a practical experience of being in business for myself, taking responsibility for myself, learning about the whole end of the business, buying my product, delivering it, collecting the money for it. And my argument for having a correction—and I would like to see us do it this year—is to deal with these lawsuits concerning the independent contractor status of distributors and paper boys.

I think it is very important that we take action to see that we do not turn paper boys into employees of the newspaper. If we do, we are going to exclude young teenagers from that profession. I think we are going to deny our country a great educational experience—experience that most people get at no other point in their lives.

I mean, go out and explain to a paper boy how a minimum wage law is going to help him. Explain to him how government could come in and raise his wages as a paper boy without either affecting the price he pays for the newspaper or the amount he collects when he collects for the paper. And any newspaper boy in America would laugh in your face.

It is that kind of experience and education that we have too little of, Madam Chairman, and I hope that we can take whatever action we need to preserve the institution of the paper boy in America. I think it goes beyond the independent contractor issue, and I think it goes beyond this whole tax debate.

This is an institution in America that needs to be preserved, and

that is what I wanted to come over and say this morning.

Chairman JOHNSON. Thank you very much, Senator. I agree that the term "paper girl" somehow does not work very well. On the other hand, there are lots of young women delivering papers. There was a lot of opposition to that. Parents were afraid about young girls being out, and not afraid about young boys being out.

We have overcome that, and I think that is part of the progress women are making, and it is not surprising that more small businesses are being founded by women in today's America than by men. Very independent-minded. Thank you for your testimony.

Chairman Johnson. Representative Christensen.

STATEMENT OF HON. JON CHRISTENSEN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEBRASKA

Mr. CHRISTENSEN. Thank you, Madam Chairman. Yesterday when I got on the plane, I happened to sit by an IRS official from Omaha. I said we were having a hearing today on this important issue, and he replied, I sure hope you can help us because, he said, the 20-point test that we have to administer is too difficult, and anything you can do in this area would ease our job.

So, I preface my remarks by saying that, because oftentimes we can use the IRS as an excuse or easy to blame, but they are having

a difficult time with this 20-point test.

Under the Code, you are either an employee or you are an independent contractor. Some workers are categorized by law as one or the other. Other workers may be classified as independent contractors under the safe harbor of section 530. Those not fortunate enough to fall under these two classes fall under the IRS' infamous 20-point test.

Almost everyone agrees that the 20-point test is far too subjective. It is quite possible to take two seemingly identical situations and find employee status in one and independent contractor status in another.

According to one estimate, this past year the IRS had 439,000 independent contractors that they had to reclassify, and the collection of \$678 million in fines and taxes that were collected just since the mideighties. The IRS' actions have been especially deadly to all small business people, not just paper boys.

Unlike their Fortune 500 counterparts, our Nation's small businesses cannot afford the fancy tax lawyers and litigators needed to defend themselves against the IRS. Consequently, rather than fighting the IRS in the use of its murky 20-point test, many entrepreneurs are forced to close their doors, putting countless industrious Americans out of work.

That is why, as you said earlier, this was the number one issue of the White House Conference on Small Business in 1995. As a result of that conference on June 30th, just 2 weeks after the close of the White House Conference on Small Business, I and 100 original cosponsors introduced H.R. 1972, the Independent Contractor Tax Simplification Act.

Unlike past attempts to resolve this issue, H.R. 1972 defines who is not an employee. It establishes distinct, clear and objective criteria for those seeking to perform services as an independent contractor. These new criteria may only be used if the independent contractor and the business for whom the services are being performed correctly complied with income reporting rules.

Specifically, H.R. 1972 establishes a three-part objective test for determining whether someone is not an employee. To qualify as an independent contractor, you must meet all three parts: Independ-

ence, investment, and contract.

Some argue the tests in my bill could make it easier to classify workers as independent contractors. That is neither the purpose nor the effect of my bill. It certainly makes it easier to tell if someone is an independent contractor, but without a substantial degree of independence and investment in business, no one, no one, can meet these tests.

The fact is that my bill would protect workers from the current abuse of designating workers who are clearly employees as independent contractors. One of the purposes of the bill is to clarify the law to such an extent that employers can no longer hide in the shade of the 20-factor test gray areas.

It is also important to note that my bill does not eliminate the 20-factor test, nor section 530. It simply provides for a simpler alternative test that can be used if you comply with all income

reporting requirements.

We are in a changing world. No longer will the majority of Americans earn a living in the fields and factories that many of us and our ancestors toiled in. Rather, we are at the brink of the third wave information age. This new era will feature new kinds of employment relationships, where people can work out of their homes and telecommute, where individuals can serve customers all over the world at the push of a button. It will foster the entrepreneurial spirit which has made this country great.

This new era has the potential of bringing enormous improvement into the lives of all Americans. Our laws should encourage, not hinder, this development. That is precisely why we need to adopt a new, clear, objective standard for determining who is self-employed and who is not, a standard based on freedom which al-

lows those who wish to benefit from this new era to do so.

In closing, Madam Chairman, I wanted to thank you for convening these hearings as soon as you did because it is an area we have to act on. And, as Senator Gramm said, it would be nice to be able to act on it this year since the White House Conference on Small Business said this is their number one priority.

Thank you for the opportunity to testify.

[The prepared statement follows:]

JON CHRISTENSEN

COMMITTEE: BLAYB AND MEANS SUBCOMMITTEE: HEALTH SOCIAL SECURITY

REPUBLICAN TASK PORCE



MARK FAHLESON CHEF OF STAFF

Congress of the United States Douse of Representatives

20515-2702

Testimony of Representative Jon Christensen Before the Subcommittee on Oversight of the Committee on Ways and Means June 4, 1996

Madam Chairman, I want to thank you and the other members of the Subcommittee for this opportunity to testify on the importance of clarifying federal tax provisions with respect to independent contractors. See a Engravery 1982 Water Web 2017

"THE IRS WAGES WAR ON THE SELF-EMPLOYED." "REBUFFING IRS ATTACKS ON WORKERS." "REVENGE OF THE TAX MAN." The headlines go on and on. These are recent articles about how the Internal Revenue Service has used murky, subjective criteria to target honest, self-employed entrepreneurs and reclassify them as employees.

and the about now the internal revertine service has used intaky, studyed we criteria to target honest, self-employed entrepreneurs and reclassify them as employees.

Let me lay out some background on this pervasive problem. Although in today's high-tech world there are many working relationships between businesses and individuals, the Internal Revenue Code classifies all such relationships into just two categories: Either you are an "employee" or an "independent contractor."

Some underer see categorized by low as one or the other. Other workers may be

Some workers are categorized by law as one or the other. Other workers may be classified as independent contractors, with a reasonable amount of certainty, under the safe harbors enacted in Section 530 of the Internal Revenue Code. Those not fortunate enough to fall under these two classes are carefully scrutinized under the IRS' infamous 20-factor test derived from common law.

What does it matter whether someone is an "employee" or an "independent contractor"? This distinction is important because it determines whether the payor or the payee is responsible for withholding income tax and the payment of FICA and unemployment. In other words, it has little to do with how much tax gets paid, but everything to do with who pays.

attention to the work, it has the to do with now much tax gets pand, but everything to do with who pays.

Almost everyone will agree that the 20-factor test is unclear and far too subjective. It is quite possible to take two seemingly identical situations and find employee status in one and independent contractor status in another. Nevertheless, in recent years the IRS has bludgeoned small businesses over the head with the 20-factor test, targeting truckers, florists travel agents computer impropers.

florists, travel agents, computer programmers, even ministers.

According to one recent estimate, the IRS war on our nation's job creators has resulted in the reclassification of 439,000 independent contractors and the collection of \$678 million in fines and taxes since the mid-1980s.

The IRS's actions have been especially deadly to small businesspeople. Unlike their Fortune 500 counterparts, our nation's small businesses cannot afford the fanney tax lawyers and litigators needed to defend themselves against IRS legal hit squads. Consequently, rather than fighting the IRS and its use of the murky 20-factor test, many entrepreneurs are forced to close their doors, putting countless industrious Americans out of work.

America's small businesspeople have finally said enough is enough. Last summer, the White House Conference on Small Business convened in Washington to debate a whole host of issues important to our nation's entrepreneurs. The top vote-getter at the Conference was a proposal to clarify the standards for determining whether an individual is an employee or independent contractor.

Specifically, the delegates recommended that Congress "should recognize the legitimacy of an independent contractor," stating further that the current common law twenty-factor test is "too subjective." The Conference delegates called upon Congress to

establish "realistic and consistent guidelines."

Those on the front lines have spoken and we've listened. On June 30th of last year, just two weeks after the Small Business Conference, I and 100 original cosponsors introduced H.R. 1972, The Independent Contractor Tax Simplification Act. Unlike past attempts to resolve this issue, H.R. 1972 defines who is not an employee. It establishes distinct, clear and objective criteria for those seeking to perform services as an independent contractor. These new criteria may only be used if the independent contractor and the business for whom the services are being performed correctly comply with income

Specifically, H.R. 1972 establishes a three-part objective test for determining whether someone is not an employee. To qualify as an independent contractor, you must meet all three parts. Two of the parts contain subparts, but you must only meet one to

satisfy that part. Let me go through the criteria briefly.

Part One: Investment. Does the individual: (1) have a significant investment in training or assets; or (2) incur significant unreimbursed expenses; or (3) agree to work for a specific time or complete a specific result, and is liable for damages for failure to perform; or (4) receive compensation primarily on a commission basis; or (5) purchase a product for resale? If the individual satisfies any one of these subtests, then Part One is met.

Part Two: Independence. Can the individual demonstrate just one of the following subparts: The individual (1) has a principal place of business; or (2) does not primarily provide the service in the service recipient's place of business; or (3) pays a fair market rent for use of the service recipient's place of business; or (4) is not required to perform service exclusively for the service recipient and (a) has performed a significant amount of service for others; or (b) has offered to perform service for others through advertising, individual written or oral solicitations, listing with agencies, brokers, or others; or (c) provides service under a registered business or trade name. Meet any one of these four subtests and you satisfy Part Two.

Part Three: A Contract. Is there a written agreement between the parties? This helps clarify each parties responsibility for the payment of taxes thereby aiding compliance.

That's it. Meet all three parts -- independence, investment, and contract -- and you qualify as an independent contractor. But remember the independent contractor and the business for whom the services are being performed must correctly comply with income reporting rules. If they fail to do so, then they are left with the burdensome 20-factor test and all of its traps.

It is important to note that my bill does not eliminate the 20-factor test nor the safe harbors under Section 530. It simply provides for an alternate test that can be used if you

comply with all income reporting requirements.

As a matter of public policy our tax laws should not favor employee status over independent contractor status, or vice-versa. Individuals should be free to enter into business arrangements of their own choosing without the IRS pushing them into one category or the other.

Despite a well-documented record of discouraging independent contractor status, the IRS is now on record that it will not discriminate against independent contractors. Margaret Richardson, Commissioner of the Internal Revenue Service, told delegates to the White House Conference on Small Business that the IRS "does not care whether someone is an employee or an independent contractor as long as they properly report their income." H.R. 1972 clearly satisfies her reasonable request and I look forward to working with Mrs. Richardson on this important issue.

We are in a changing world. No longer will the majority of Americans earn a living in the fields and factories that many of us and our ancestors toiled in. Rather, we are at the brink of the Third Wave Information Age. This new era will feature new types of employment relationships, where people can work out of their homes and "telecommute," where individuals can service thousands of customers all over the world through the push of a button. It will foster the entrepreneurial spirit that has made this country great. This new era has the potential of bringing enormous improvement to the lives of all Americans.

Our laws should encourage, not hinder, this development. That's precisely why we need to adopt a new, clear, objective standard for determining who is self-employed and who is not -- a standard based on freedom and which allows those who wish to benefit from this new era to do so.

In closing, I want to again thank you, Madam Chairman, and my colleagues on the Subcommittee for the opportunity to testify before you today.

Chairman Johnson. Thank you, Representative Christensen, for your leadership on this issue.

Representative Kim.

STATEMENT OF HON. JAY KIM, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF CALIFORNIA

Mr. Kim. Thank you, Madam Chairman. I would like to thank

you again for giving me this opportunity.

As my colleagues mentioned, there are a lot of horror stories about this issue. Many times businesses hire someone who they think is legitimately an independent contractor. Later the IRS apologizes and tells them that they should have been employees. The penalty for this honest mistake, is massive fines, back taxes, and legal fees. Many of them just go bankrupt.

IRS does not give businesses the benefit of the doubt. As my colleague mentioned, they have a 20-factor test. If you meet 19 of them only, you can be fined. The IRS is very aggressive about this.

It is not entirely their fault. Congress passed the laws that are

causing the problem.

In 1990, the IRS assessed more than \$100 million in fines against small businesses for misclassifying workers. But the reason they could do this is Congress' failure to clarify the law. My bill would try to clarify and correct that madness.

Now, my bill has three sections. One of them is defining what the independent contractor is, which is almost identical to my

colleague Mr. Christensen's bill. Very simple.

First of all, you have to have some kind of written agreement. That is common sense. In addition to the written agreement, you have to have one of the following four criteria: One is you have to suffer a profit loss. Come on, if you do not have that, how can you be an independent contractor?

Or, you have to have a separate principal place of business and some kind of investment; or he or she shall be paid exclusively on a commission basis; or offer the same service to other general

public.

That is it. As long as you meet the criteria, written agreement plus one of those four criteria, then he or she shall be an independent contractor. There is no question about it; the IRS cannot interpret it otherwise.

Now, what is the difference between the Kim and Christensen bills? Mine goes a little deeper. My bill reforms section 530 and compliance rules. That is what I would like to talk about this morning.

Let me explain quickly what I mean by section 530. As you know, in 1978, Congress passed an amendment called section 530. It was supposed to be temporary, to try to protect the small businesses from the IRS.

Now, let me tell you what my bill would do in terms of changing section 530. Right now, according to the IRS rules, a business can be found in violation of the consistent treatment. The phrase, "consistent treatment," what it is is if you are an employer trying to change one of the independent contractors to a permanent employee, you cannot do that. You are going to be fined by IRS because the phrase, "consistent treatment" is violated. This is ridicu-

lous. It discourages you from hiring an independent contractor as an employee.

My bill changes that. You can go ahead and hire him if you want

to, if the two parties agree, and not risk IRS prosecution.

Second, section 530 gives no concrete standard for what constitutes a significant segment of the relevant industry. It is ambiguous. Mine clearly defines what that means. My bill defines "significant segment of industry" as no more than 25 percent of industry.

Where did I get that? We contacted a lot of businesses and industries, and looked at court rulings. They told me 25 percent is a reasonable figure; as long as you have 25 percent or more, that should be considered a significant sector.

Right now it is very ambiguous. My bill changes that.

Third, there is a lot of confusion about certain independent contractors being treated as independent contractors for employment taxes, yet in terms of other federal taxes, they are treated as employees.

Let me give you one example, a real estate agent, for tax purposes, is an independent contractor, yet he/she is treated as an employee when determining who is a qualified individual for a profit-sharing system or stock bonus plan.

There is a contradiction in here. In another example a tax court ruled that Methodist ministers are employees, so they cannot get credit on automobile allowances, yet they are independent contractors for Social Security taxes.

This inconsistency has to be eliminated, and my bill does that. It simply eliminates inconsistencies and qualifies what they mean

by this examination of employment and taxes.

Finally, my bill deletes section 1706 of section 530. In 1986, Congress passed another amendment trying to exclude technical services people who work through brokers from section 530 protection. I do not know why they did it. This is ill written, it is not fair. My bill simply eliminates this.

Everybody is equal and fair; as long as they meet the definition tests, they shall also be treated as an independent contractor. They

are not going to be excluded from section 530 protection.

Finally, we added compliance reforms so that nobody can call this bill extreme. My bill asks the employer to be more responsible. For example, we asked an employer to line list his or her Form 1099 income. In other words, when a worker files his or her tax return, he or she has to list an independent contractor income, rather than a lump sum, so that the IRS can audit easier.

It is an additional responsibility for the employer to list additional incomes when they file a Form 1099—but it will help greatly. I raised the fines from \$50 to \$75 per offense for businesses who fail to issue Form 1099s, and \$100 to \$125 per offense for doing so intentionally.

In other words, the employer, an independent contractor, takes a little more responsibility; in return, section 530 is clearer and gives businesses more protection. I think it is a fair trade and a very comprehensive reform.

I also support Mr. Christensen's bill. I am an original cosponsor. But, I believe mine is much more comprehensive, and therefore I urge you to pass my independent contractor reform legislation as soon as possible.

Thank you, Madam Chairman.

[The prepared statement follows:]

Statement of Congressman Jay Kim (R-CA) House Ways and Means Committee Subcommittee on Oversight June 4, 1996

Madam Chairwoman, members of the Subcommittee, thank you for the opportunity to testify here today. I believe that independent contractor reform is the ultimate small business issue, so I am extremely pleased that you have chosen to have this hearing.

As many of you know, I used to own and operate a business. I ran a small engineering firm in Southern California called JayKim Engineers which, at one point, had 150 employees. Over the years my firm used many independent contractors – accountants, consultants and others. I know from firsthand experience exactly how confusing, ambiguous and arbitrary the current worker classification rules are.

In my short time as a Congressman, I have learned that I was not alone in having difficulties with worker classification rules. I have heard horror story after horror story from my constituents about how they hired someone they thought was a legitimate independent contractor, only to have the IRS swoop in years later, claim that the worker (or workers) should have been an employee, and impose massive fines and back taxes. Often, these businesses are faced with severe financial problems and, in some cases, bankruptcy as a result of an honest mistake in classifying workers.

For this reason, I was not surprised to see that the White House Conference on Small Business identified independent contractor issues as the #1 issue for small businesses. I think that this statement should serve as a clarion call for all of us who care about the future of small businesses in this country.

The independent contractor issue illustrates one of the fundamental truths of our government: Wherever Congress leaves ambiguity in the law, a federal agency will use the ambiguity to usurp as much power as possible.

And that is exactly what the IRS has done with the worker classification rules. There exists an abundance of anecdotal evidence to suggest that the IRS consistently interprets these rules in the most restrictive way possible. The IRS is clearly not "neutral" on whether or not a worker is an employee or an independent contractor. The fact is, the agency has a bias against the independent contractor status, and as a result, puts the burden of proof on the taxpayer to prove that the worker is <u>not</u> an employee.

In short, the IRS has taken an extremely aggressive and hard-line stance on independent contractor issues — and it has gotten more aggressive every year. Between 1987 and 1990, for example, the IRS' Employment Tax Examination Program (ETEP) grew from a small pilot program to a major undertaking which, in 1990, employed 19,000 revenue officers who examined more than 20,000 tax returns. These reclassifications resulted in \$111 million in assessments against small businesses. That's \$111 million dollars that could have been spend to hire more workers, to make capital investments, or to open new businesses. And this cost figure does not even include the tens millions of dollars that small businesses must spend every year on legal fees to defend themselves against IRS prosecution.

Given these facts, it would be easy to blame the IRS for the problems in our worker classification system. But, to be honest, I really think that most of the blame does not lie with the IRS, it lies with Congress.

The fact is, despite the massive heartburn that worker classification rules have caused small businesses over the years, Congress has done almost nothing to clarify the distinction between employees and independent contractors. The passage of Section 530

in 1978 helped, but it was only supposed to be a "stop-gap" measure. When this measure was passed, it was expected that Congress would return to independent contractor issue in short order to fix the problems that necessitated Section 530. Unfortunately, Congress never did, and the problems that small businesses face in dealing with the worker classification rules have gotten much, much worse.

And the unfortunate fact is, these problems will continue to get worse until Congress gets involved with the independent contractor issue. In the absence of a clear definition of who is and who isn't an independent contractor from Congress, the IRS will continue to take advantage of ambiguities in the law to harass honest small business owners.

For this reason, I strongly believe that it is time for Congress to get off of the sidelines and reform the worker classification system. That is why, last January, I introduced H.R. 582, the "Independent Contractor Tax Fairness Act". The idea behind H.R. 582 is simple: It is time for Congress to establish a clear, unambiguous test for what constitutes an independent contractor.

To that end, the core of my bill is a simple test that establishes who is <u>not</u> an employee. The test has four criteria that are based on common-sense requirements for who qualifies as an independent contractor. If a worker meets any one of the four — and has signed a written agreement clearly stating that both parties understand the responsibilities of independent contractor status — then he or she cannot be considered an employee and the IRS is prevented from reclassifying the worker (and assessing associated fines and penalties).

In short, H.R. 582 establishes clear, easily understandable criteria for determining whether a worker is or is not an employee. Instead of having to wade through the current swamp of worker classification rules, most small businesses can look for guidance and protection to the four common-sense criteria established by the bill. In doing so, I believe that H.R. 582 would help small businesses by providing badly needed clarity to the worker classification rules.

At this point, I would like to make a couple of points about H.R. 1972, the independent contractor bill established by our freshman colleague. Mr. Christensen.

Many of you will note that I am an original cosponsor of H.R. 1972. I support this bill because I believe that, at their core, both H.R. 1972 and my bill, H.R. 582, share the same underlying intent: To establish a clear and unambiguous standard for who is not an employee. In fact, the tests established by both bills are extremely similar -- although the test in Mr. Christensen's bill is slightly more flexible in its application.

Where our bills differ, however, is in whether and how they address other important problems with our worker classification system. H.R. 582 builds on the same foundation as H.R. 1972, but also contains a more comprehensive attempt to address many of the other underlying problems with the worker classification rules. To put it simply, H.R. 1972 is the minimum we should do; H.R. 582 represents a broader overhaul of the worker classification system.

For example, H.R. 582 makes badly needed changes to the so-called Section 530 rules that help businesses who make honest mistakes in classifying workers. These include: Allowing businesses to convert independent contractors to employees without threat of losing Section 530 protection; clarifying the threshold for what constitutes a "significant segment" of an industry; repealing the section 1706 exemptions for technical workers; extending classification rules to all federal taxes, not just employment taxes; and narrowing the current prior audit safe harbor.

These provisions, I believe, will strengthen Section 530 and provide businesses with additional protection against IRS overzealousness.

Equally importantly, the bill contains strong compliance provisions which would encourage independent contractors to more completely report their income. These most important of these compliance provisions would require independent contractors to "line-list" 1099 income. This would allow the IRS to detect unreported payments and, in doing so, improve income reporting among independent contractors.

In addition, the bill increases the penalty for not issuing 1099's to workers. According to a recent GAO study, issuing a 1099 to a worker dramatically improves the chances that an independent contractor will report their income. H.R. 582 would help ensure that 1099's do indeed get issued. Finally, H.R. 582 requires the IRS to undertake a substantial education campaign to inform businesses about the changes made by the bill.

In short, H.R. 582 takes a balanced approach to the independent contractor issue. It substantially clarifies worker classification rules and gives businesses better protection from being persecuted for honest mistakes — making it easier and less risky for businesses to use independent contractors. In return, however, the bill requires that businesses and the independent contractors they hire are more accountable for the income that is generated as a result of their professional relationship. I believe that this is a very fair trade.

To sum up, I believe that H.R. 582 represents a balanced and comprehensive attempt to address the problems in the worker classification system. I would urge this committee to consider adopting such a comprehensive approach to this issue. Since Congress will probably only have one chance in the near future to deal with independent contractor issues, I believe that we should be as thorough as possible in reforming the system.

Whatever approach we take, however, I believe that the independent contractor issue must be dealt with, and soon. There are few issues which are having more impact on the lives of small business across the country. It is my hope that, with the new Republican Congress, we can act quickly to remove this onerous regulatory burden from the backs of small businesses.

Madam Chairwoman, I would like to thank you again for the opportunity to testify today. I look forward to taking any questions you or the committee may have.

Chairman JOHNSON. Thank you very much, Representative Kim. Your bill does go further in some regards than Representative Christensen's bill, and certainly this issue of the Form 1099 is an important one. Employers have to bear their full responsibility, because in the end a good Tax Code requires everybody to pay their fair share, and the evidence of noncompliance is quite clear.

Mr. KIM. That is where the cheating comes from. Once you identify line by line, it is difficult to cheat, and also, it will be easier for the IRS to audit their books. I think it goes two ways. That is

not just one way, it is two ways; it is balance.

Chairman JOHNSON. We will also look very closely at the proposals you made in regard to section 530. There are some problems there.

I was not aware of the problem in section 1706, and we will certainly look at that.

Mr. Christensen, in regard to the compliance issue, would you be interested in working with us to improve the information reporting requirements that are proposed on both independent contractors and businesses?

Mr. CHRISTENSEN. Absolutely. I would be more than happy to work with the Committee and, Congressman Kim, to put together some compliance measures so that we could make sure that that is a part of our bill.

I guess the one thing I want to emphasize though is, I come from a different angle. I think that this legislation is so important. First of all, I do not think we should be looking at people saying that the independent contractors are basically looking for a way to get around the payment of their taxes and for ways to hide or where to hold their income.

Basically, I think that the independent contractors have given this country a large percentage of the new jobs and new growth and new opportunities. So, I look forward, to working with you on

some compliance measures.

One of the things I am very concerned about is, there has been some talk about withholding. I want to let the Chairwoman know that this would be disastrous. It would have a disastrous effect for the small business owners, and it would be disastrous for a number of people out there, including direct sellers. I could see it being not only a bureaucratic nightmare with paperwork in that area, but it would also take away the total effect of wanting to go into business for yourself and wanting to be an independent contractor.

I would just like to alert the Chairwoman to that issue, because I believe that would have a disastrous effect. I would strongly urge away from proceeding with my bill if that was even a consider-

ation.

Chairman JOHNSON. What is the logic for retaining the 20-point test if we clarify the law? Anyone on the panel is welcome to comment on this.

Mr. CHRISTENSEN. First of all, under my test—the independence, investment, and contract—if you meet all three, there is no need for the 20-point test. But if you do not meet the three areas under my bill, then the 20-point test still applies. So, that is one of the reasons that I think we should keep that 20-point test there.

We are not looking for a way to get around the law, but just to make it easier and simpler for the IRS to administer.

Chairman JOHNSON. Thank you.

Would your bill repeal or retain section 530?

Mr. Christensen. It would keep section 530 as is.

Chairman JOHNSON. Thank you.

Mr. Matsui.

Mr. MATSUI. Thank you, Madam Chairman. I would just like to ask Mr. Christensen a couple questions.

Jon, do you know how many people, employees, currently classified employees in the country today, would be affected by your legislation?

Mr. CHRISTENSEN. I do not have that figure.

Mr. MATSUI. I would imagine that CBO or somebody would have the figures.

Chairman JOHNSON. If the gentleman will yield, did you get a revenue estimate?

Mr. Christensen. Yes. It is roughly under \$1 billion.

Chairman JOHNSON. I think we could probably work back from that and find those numbers.

Mr. MATSUI. All right. Do you know what category of jobs are

affected by your bill? Can you describe what it might be?

Mr. CHRISTENSEN. I can tell you the general areas. There are over 400 different types of independent contractors in service areas out there, from florists to truckdrivers to paper boys, direct sellers. Over 400.

Mr. MATSUI. What I am trying to find out is, who would actually be affected by your bill? What job classifications? Could you give me a few examples?

Mr. CHRISTENSEN. Well, for example, a truckdriver, an independent contractor, or a florist who owns his or her business.

I am not sure I follow your question.

Mr. MATSUI. OK. So, right now a truckdriver or a florist is considered to be an employee. Maybe; maybe not.

Mr. Christensen. Maybe; maybe not. That is the problem with

the 20-point test.

Mr. MATSUI. I am trying to understand what your legislation—how the relationship will be impacted. You have three tests. Under test 1, you have 5 possible conditions; you need to satisfy one; if a person has significant investment, assets, or training.

Test 2: A worker must either have a principal place of business,

plus five other possible conditions.

Test 3 is an agreement. Anybody can draft an agreement.

So, you basically have two tests. An airline pilot, for example, has significant investment in assets or training. An airline pilot goes to airline pilot training school, whatever that might be. He or she then has a license to fly commercially. That person then has their own principal place of business. That is two tests that are satisfied.

Does that mean that an airline pilot for United Airlines that takes me back to California would necessarily be an independent contractor?

Mr. CHRISTENSEN. Not under that scenario, Congressman.

Take the scenario of a truckdriver who owns or leases his own tractor-trailer rig. He is working with a provider who has given him some of the leads for transportation and loads, pickup loads or delivery, but he has the right to say no or yes on whether he wants to pick that load up. So, he has the control; he has the decisionmaking power. But under this scenario, he has met the significant investment test, as well as the contract test.

Mr. MATSUI. But your test—the three tests that you have here do not talk about control. You satisfy significant investment in asset or training. That is test 1. Test 2: Has a principal place of business. Test 3: Has a contract.

So, tell me why the airline pilot would not qualify as an

independent contractor under your test?

Mr. CHRISTENSEN. Under my test, the independence element is your controling element. It does meet that test. Under an airline pilot, they do not have that independence to decide whether or not they want to fly to Philadelphia or to Florida. There is no independence there. So, arguably, they would not meet that test.

Mr. MATSUI. But you have three tests. I am trying to understand this. Maybe we reached the point where we just cannot resolve

this.

If I am not mistaken, you have test 1, a worker must meet one of the five conditions, have significant investment in assets or training, incur significant unreimbursed expense, agree to perform services for a particular amount of time, or to complete a specific result and be liable for damages, to be paid primarily on a commission basis, or purchase products for resale.

Those are the five conditions under test one. The worker must satisfy one of those tests. OK. Assuming that the worker satisfies the test of having a significant investment in assets or training, that is test one. An airline pilot goes to school, as I said, and

satisfies that test.

Then you have test 2, six criteria. You only need to satisfy one of the six. Has a principal place of business; OK. That airline pilot has a principal place of business. He declares one.

Then test 3——

Mr. CHRISTENSEN. Congressman, under that scenario, the airline pilot would not pass that test. Under the place of business, because he does not own or lease or put any money into that place of business, he is an employee under your scenario.

Mr. MATSUI. We do not know that. The airline pilot may have leased a facility, may have separated part of his home. The home office rules we are changing right now, that might qualify as an

office.

Then obviously an employment contract. United signs a contract with that pilot. All of a sudden, the pilot is an independent contractor.

I am trying to understand what your bill does. I mean, we are trying to come to some conclusion here. You are telling me that the airline pilot would not comply, and I read your rules and give you a scenario, and it appears to me the airline pilot complies as an independent contractor.

You are going to have to help me with this.

Mr. Christensen. I would be glad to work with you in that area.

Mr. MATSUI. You are saying there is another element of control. Mr. CHRISTENSEN. The independence factor is analogous to your control element. The airline pilot would not meet the independent factor. He is taking his orders from a central area. He is taking his orders from the authority on where they need to fly to and where to fly from, versus an independent contractor, a truckdriver.

Mr. MATSUI. That is where our problem is, I guess, because your bill does not talk about control. The bill talks about these three cri-

teria and conditions within it. But you do not have control.

Now, are you suggesting that case law will be part of your legislation? Because if you are, that just could add more complexity.

Mr. CHRISTENSEN. Under the airline pilot scenario, the supervision aspect would definitely control that area. But one of the things about my test that I think is different from Congressman Kim's test is—

Mr. Matsul. I am not asking about Congressman Kim's test.

Mr. CHRISTENSEN [continuing]. You have to take all three of the areas, the independence, the investment, as well as the written contract.

Senator GRAMM. I was telling the Chairman I have to go.

Mr. MATSUI. I do not have any questions for you.

Chairman JOHNSON. Mr. Laughlin, would you like to ask the Senator any questions?

Mr. LAUGHLIN. No.

Chairman JOHNSON. Thank you very much for being with us, Senator. We appreciate it.

Mr. MATSUI. Jon, are you saying that there is an element of con-

trol in your legislation? Because there isn't in your bill.

Mr. CHRISTENSEN. Under the independence factor, you have that control aspect, because you—as I say, a truckdriver, would have the authority to go to New York or to go to Philadelphia, to make that decision for yourself, versus taking the supervisory role and having that decision made for you.

Mr. Matsul. This is obviously a very important subject.

You will have to give me the forbearance of asking this question. The florist asks a truckdriver to drop flowers off at 2015 K Street, an office. A gentleman calls on Mothers Day and says, "Will you send flowers to my mother?" The florist tells the truckdriver, "I wanted this delivered by a certain time, 11 o'clock in the morning," because that is what the client or customer wanted. "In addition to that, I want to make sure that the flowers are well preserved before they get to the office, because obviously I want to preserve business."

Is that control? Explain to me what control is then.

Mr. Christensen. I have to have more information from you.

Does the truckdriver own his own rig?

Mr. MATSUI. I am afraid some of the people in the audience are going to be a little unhappy, because then you go right back into this law, complexity. Obviously the service will have some problem. This issue is much more complex than three tests.

If you want to bring control under this thing, there are literally thousands of cases in the United States on what is control, how do you define an independent contractor from an employee. So, this is not just an issue of, you know, significant investment in training.

Obviously, a place of your own business and, third, a contract. This is a very difficult issue to resolve. Once you get into control, what is control?

Mr. Christensen. That is—I would agree. That is why the 20-

point test has been so hard to interpret and enforce.

Mr. MATSUI. Exactly. We have a lot of work to do on the 20-point test.

Mr. CHRISTENSEN. The commissioner just came out with a training manual that is somewhat simplified, but it is still very murky and hard to administer.

Mr. MATSUI. You are saying in your bill you are willing to put in the element of control?

Mr. CHRISTENSEN. To get that independent contractor, he has to make a decision on whether or not to accept that job.

Mr. MATSUI. OK. I have no further questions.

Chairman JOHNSON. Mr. Laughlin.

Mr. LAUGHLIN. Just to follow up on that, it seems to me there is a real differential in the airline pilot and the truckdriver that Mr. Christensen talked about. The airline pilot does not get on any airline, as I understand it, without authority from the company or direction from the company, and certainly has a lot of other authoritive controls on where he flies and how he flies that the truckdriver may not have.

Mr. MATSUI. If the gentleman is directing that question to me, I agree. The only problem is, it is not in the bill. It is not in the bill. Somebody will have to resolve that issue.

Chairman JOHNSON. If the gentleman will yield.

Mr. Christensen, as I read your bill, to be independent, the service provider cannot just have a principal place of business. The bill reads, "The service provider, A, has a principal place of business; B, does not primarily provide the service in the service recipient's place of business; or." But those first, it would seem to be coupled together.

It does not appear to me from your bill, having a principal place of business is sufficient. The "or" comes after the two are coupled together and goes on to say, "or pays a fair market rent for use of a service recipient's use of business, or", the next section, 2, is quite long and it has many parts to it. I do not think just having a principal place of business under your bill is sufficient.

Mr. CHRISTENSEN. That is correct, Madam Chairman.

Mr. MATSUI. So, you are saying, if I may——

Chairman JOHNSON. No; what I am pointing out is, the "or" comes after B, not after A. A and B are required before you get to the "or."

Mr. MATSUI. You are saying A and B are required? That is not grammatically correct.

Chairman JOHNSON. That is my question.

Mr. MATSUI. That is not how it is construed. It has a principal place of business, does not primarily provide the services in the service or recipient's place of business, or pays fair—A, B, and C.

Chairman JOHNSON. That is why I directed my question to

Congressman Christensen.

Mr. CHRISTENSEN. That is correct, Madam Chairman.

Chairman JOHNSON. This is the kind of thing we will pursue in greater detail among us. We have to have the matter cleared up, and the issue Congressman Matsui brought up is worthy of our attention.

Mr. LAUGHLIN. John and Jay, I want to compliment you for getting us started. The discussion points out why we appreciate the

spirit in which both of you wanted to cooperate.

I can think of one newspaper in my State that is very concerned about what we do about the newspaper boy. I use that term, since my younger brother and I learned many valuable lessons being newspaper boys. Frankly, I would like to change it to make everyone that works for that company an employee, so it would put them out of business, because they never wrote one kind thing about me. But that is not the approach we need to be taking on this bill and this hearing.

Mr. KIM. Are you referring the question to me?

Mr. LAUGHLIN. I am not even putting a question, Jay. But if you want to respond, I was going to reserve the questions until the opportunity we can work together and go to the next witness. If you want to respond to what I said, Jay, I am happy to hear you on my time.

Mr. KIM. I will await my turn then.

Chairman JOHNSON. I thank the gentlemen very much for your

thoughtful proposals in this area.

Mr. Christensen, it is rare that freshmen are assigned to this Committee. You are one of those who was assigned in your freshman year to the Committee on Ways and Means, and you have made a very important contribution in proposing this legislation.

Your experience, Mr. Kim, as a small business man with section

530 will be very helpful to us. Thank you.

Mr. Christensen. Thank you, Madam Chairman. I would like to say I look forward to working together with you and Congressman Matsui to clarify this area and make it easier for everybody.

Chairman JOHNSON. Thank you.

The next panel will assemble, please. Sandra Abalos, a certified public accountant from Phoenix, Arizona; David Barbee, president of Hospital Resource Personnel, Inc., Augusta, Georgia; Wayne Kessler from Pennsylvania; Dave Bolt from New Jersey; and Edgar Gee from Tennessee. We have a nice collection of small business representatives on the next panel. We will start with Sandra Abalos.

Ms. Abalos, welcome. If you will proceed.

STATEMENT OF SANDRA A. ABALOS, CERTIFIED PUBLIC ACCOUNTANT, ABALOS & ASSOCIATES, P.C., PHOENIX, ARIZONA

Ms. ABALOS. Thank you. I appreciate the opportunity to testify

today. Thank you for inviting me.

My name is Sandra Abalos. I am an elected delegate to the White House Conference on Small Business from Arizona and the Region IX Taxation Chair for the Implementation Team. I am a CPA. I hold my master's in accounting, with an emphasis in taxation, and have been a small business owner for the past 17 years. My practice emphasis and expertise is with small business tax

matters, and I testify today on behalf of the small business commu-

nity.

The 1995 White House Conference on Small Business ranked the need for clarification of the independent contractor definition as the number one concern for small business. I was a cosponsor of that issue recommendation. This is such a critical issue because the 20 common law factors used today in making a status determination do not provide an answer to the question as to whether someone is an employee or an independent contractor. That determination is purely subjective, and even as tax practitioners, we are often unable to analyze the facts and make conclusive determinations with any level of assurance.

In addition, the small business community has been the target of aggressive employment tax audits with inconsistent determinations. From 1988 to 1994, 11,380 employee tax audits have been conducted, resulting in \$751 million of proposed assessments and

alleged reclassification of 483,000 workers.

Often the resulting penalties, tax assessments, and interest are so large that bankruptcy becomes the only alternative. In many cases, the cost of litigation exceeds the cost of assessment. If they win the case, they still lose the battle financially.

The Internal Revenue Service recently recognized this undue burden on the small business community, and in response they have adopted two new programs to expedite the examination process, and they have developed new independent contractor training manuals.

I have reviewed the manual in its entirety, and I commend the IRS for their efforts in attempting to provide reasonable guidance in this area. However, the training manual itself is evidence that

this issue is in need of legislative clarification.

The manual is over 100 pages long. It focuses on evidence of behavior and financial control and ultimately is a subjective interpretation of the evidence. I do not believe that this will alleviate the problems of inconsistent and incorrect application of standards by IRS examiners. Retraining is just simply not enough. Legislation is needed to provide specific, definitive criteria for determination.

If the IRS puts in this much time and resources to try and resolve their internal understanding of this issue, then I ask you, how can the small business community ever hope to comply with any level of assurance? We do not have those kinds of resources.

Åll these efforts are aimed at treating the symptoms of this issue. Instead, we need to cure the cause. House bill 1972 provides definitive criteria for determining who is an independent contractor. The requirements are clear, they can be answered definitively, and they do not lend to subjective determination.

The language and testing requirements are such that small business owners and practitioners can make a determination of a worker's status with a reasonable level of assurance, and this is the key

issue before you.

The White House Conference delegates' regional tax chairs understand that there is concern that House bill 1972 may prompt a reclassification of workers currently treated as employees. Please understand that the small business community wants clarification of the criteria, not a redefinition of who may be an independent

contractor. We are looking for a workable solution that achieves balance and equity for all that are affected.

In my written testimony, I have made suggestions of ways to deter employee reclassification at the employment level. This concern can be addressed and should not be an effect of clarification.

In closing, I ask Congress on behalf of the small business community to continue the process to provide us with rules we can follow. We believe that consistent criteria will provide a clear line for determination, will create equity among industries, will protect workers from reclassification, and businessowners from redetermination; and, in addition, we believe that consistent criteria will enhance compliance. This can be a positive resolution for everyone.

I sincerely appreciate the opportunity to testify, and I welcome

any questions you may have.

[The prepared statement follows:]

STATEMENT OF SANDRA A. ABALOS, CPA OF ABALOS & ASSOCIATES, P.C.

The Honorable Nancy L. Johnson, Chair Subcommittee on Oversight Committee on Ways and Means 104th Congress of the United States House of Representatives 1136 Longworth House Office Building Washington, D.C. 20515

Dear Madam Chair and members of the Subcommittee:

I testify today on behalf of the small business community. I am an elected delegate from Arizona to the 1995 White House Conference on Small Business and the elected Region IX Taxation Chair for the Implementation Team. I am a Certified Public Accountant, hold a Masters degree in accounting with an emphasis in taxation, and own a public accounting firm with eight employees. I began my own small business upon graduation from college seventeen years ago. Our practice emphasis and expertise is with small business and small business tax matters.

The 1995 White House Conference on Small Business ranked the need for clarification of the independent contractor definition as the number one concern for small business. Debra Lessin, CPA and myself were the co-sponsors of this issue recommendation at the Conference.

This is a critical issue for small business because we have been the target of aggressive employment tax audits. From 1988 through 1994, there have been 11,380 employment tax audits resulting in \$751 million of proposed assessments and reclassification of 483,000 workers as employees. Often the resulting tax assessments, penalties and interest charges are so large that bankruptcy becomes the only alternative. Small business simply does not have the financial resources to adequately defend and litigate adverse determinations. The cost of litigation may even outweigh the cost of assessment; if we win the case, we still lose financially. These are real consequences to the small business community despite our best efforts to comply with the criteria as it exists in the 20 common law factor test.

The 20 factors do not provide an answer to the question of whether a worker is an employee or an independent contractor. This lack of a clear and objective standard causes problems for both small business and the Internal Revenue Service. The Internal Revenue Service recently adopted the Classification Settlement Program and the Early Referral Program to expedite the examination process and apply provisions under section 530 of the Revenue Act of 1978 if applicable. In addition, the Internal Revenue Service has produced a new training manual for their auditors on employee or independent contractor classification audits. I have reviewed the new training manual in its entirety and I commend the IRS for their efforts in attempting to provide reasonable guidance in this area. However, the training manual itself is evidence this issue is in need of legislative clarification. The manual is over one hundred pages long, focuses on evidence of behavioral and financial control, and ultimately is a subjective interpretation of the evidence. I believe this is the best that can be done with the 20 common law factors we have today. However, I do not believe this will alleviate the problems of inconsistent and incorrect application of worker classification standards by IRS examiners. Retraining is simply not enough; legislation is needed to provide specific definitive criteria for determination. If the IRS puts in this much time and resources to try and resolve their internal understanding, how can the small business community ever hope to comply with any level of assurance.

HR 1972, The Independent Contractor Tax Simplification Act of 1995, provides definitive criteria for determining who is an independent contractor. The requirements are clear, can be answered definitively, and do not lend to subjective determination. HR 1972 incorporates those points that are at the heart of an independent contractor relationship, requires a written contract, and submission of 1099's to the Internal Revenue Service. If the service recipient fails to comply with IRS reporting requirements, they may not rely upon the definitive criteria and are then subject to the existing 20 common law factors. The language and testing requirements of HR 1972 are such that small business owners and practitioners can make a determination of a worker's status with a reasonable level of assurance; this is the key issue before you.

I believe legislation providing a definitive testing criteria will in fact enhance reporting compliance and create worker classification consistency and equity among industries. As tax and financial advisors, we address worker classification issues more frequently than any other small business tax issue. In practice, this is considered a "gray" area of taxation, meaning that a small business can reach one conclusion based on the facts; yet the Internal Revenue Service may reach an entirely different conclusion considering the exact same facts. We find when an issue is highly subjective or "gray," there is a tendency to justify the more favorable outcome. In making a worker classification determination, business may tend to lean toward independent contractor status whereas the IRS will lean toward employee status. Thus we have the audits, appeals, classification programs, new training manuals, etc. These are all in an attempt to bring definition to who is an independent contractor. If, however, the testing criteria is such that an answer can be determined, then classification becomes a clear line. By removing the subjectivity, you take away the "gray", there is no more "leaning", compliance is enhanced, and industry classifications become consistent. Think of the productive time and energy that could be saved by clarity. Small business will comply with the rules, we simply need to be able to determine what those rules are,

The WHCSB Delegates and Tax Chairs understand the concern that HR 1972 may create reclassification of workers currently treated as employees. Please understand, the small business community wants clarification of the criteria, not a redefinition of who may be an independent contractor. The small business community is unique as we are on "both sides of the fence" with this issue. Small business owners are often independent contractors and small business owners often hire independent contractors as well as employees. We are looking for a workable solution that achieves balance for all who are affected. We are looking for a solution that creates equity and maintains compliance. We do not want a massive reclassification of employees to independent contractor status. If the Committee is concerned about rampant reclassification, perhaps you could exclude designating independent contractor status to those who are currently employees unless the 20 point test and Section 530 safe harbor tests are met.

The cost of government compliance enforcement on this issue must be astounding, not to mention the compliance costs to the small business community. With a clear definition, we could shift the focus of IRS efforts from reclassification of independent contractors to compliance with existing tax laws. With the down-sizing of corporate America, we see many more violations of worker classification issues at the large corporate level. I have a client who is an architect and has worked at the same firm for twenty years. Two years ago, the Company changed his classification from an employee to an independent contractor. He does the same job, works in the same office, the same hours, with the same direction; the only difference being the manner in which he is compensated and the benefits he is now eligible to receive. This seems a clear violation of the independent contractor definition and should be pursued by the IRS. Perhaps the IRS could explore an employment referral program where workers who are misclassified can report these cases directly to the IRS and prompt an investigation. If this were available and promoted to the public, such a program in and of itself may deter such tendencies and activities at the employment level.

Congress must provide a simple and uniform definition of independent contractor that we can all rely upon. By this I mean employers, workers, practitioners, and the IRS must all be able to analyze a set of facts and make a reasonably consistent determination. HR 1972 establishes an objective definition of independent contractor that can produce a consistent determination. I ask Congress, on behalf of all small business, to continue the process to provide us all with rules we can follow. We believe consistent criteria will create equity among industries, will provide a clear line for determination, and will protect workers from reclassification and business owners from redetermination. In addition, we believe consistent criteria will promote compliance. This can be a positive resolution for all.

I thank this Subcommittee and the 104th Congress for acknowledging the concerns of the small business community with respect to the independent contractor issue, and for working to create legislation to clarify the definition.

I sincerely appreciate the opportunity to testify and welcome any questions you may have.

Respectfully,

Sandra A. Abalos, CPA

WHCSB Region IX Taxation Chair

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Chairman JOHNSON. Thank you very much for your testimony. We can come back to questions at the end.

Mr. Barbee.

STATEMENT OF DAVID BARBEE, PRESIDENT, HOSPITAL RESOURCE PERSONNEL, INC., AUGUSTA, GEORGIA

Mr. BARBEE. Madam Chairman and Members of the Subcommittee, my name is David Barbee. I am the owner-operator of Hospital Resource Personnel, Inc., which is a nurse referral agency based in

Augusta, Georgia.

Mr. BARBEE. My business consisted of referring self-employed, independent contractor nurses to hospitals and other institutions that have peak demands for nurses. A nurse who elects to join my company's registry always has the right to accept or decline offers of assignments. The nurses are all State licensed, and my company does not provide them with any training or any instruction on how to perform those services.

During 1990, the Internal Revenue Service audited my company and contended that the company's classification of nurses as independent contractors was wrong. My attorney and I explained to the IRS representative that my company was eligible for protection under section 530 of the Revenue Act of 1978. My attorney provided the IRS representative with the detailed explanation of why

my company qualified under the safe harbor.

IRS rejected the claim based on the contingent that my company failed to comply with the Form 1099 requirements of section 530. The IRS claimed that for one period the Form 1099 had not been

filed when, in fact, all those forms had been filed.

We found the Form 1099 that my company filed for the period in question, we also obtained from many nurses their copy of the forms, that my company had sent to them, and even after showing these to the IRS, the IRS still refused to accept my company's section 530 protection. Ultimately, the IRS assessed my company over \$1 million in back taxes, penalties, and interest. The exact number is \$1.4 million.

Based on the advice of my lawyers, we paid a divisible portion of the tax submitted, submitted a refund claim which was denied,

and filed suit against the government's seeking funds.

As you probably know, after the final refund action in district court, my case was transferred from the IRS to the Justice Department. The Department of Justice recognized how preposterous the 1099 issue was and never considered it. Instead, the Department of Justice contested that my company's section 530 claim was based on the contention that my company did not satisfy the substantive requirement of the test.

Shortly after filing for the refund action, the IRS commenced aggressive collection actions against my company and sought to levy all my company's assets. My wife and I were terrified that the IRS collection actions were going to shut down the business that my wife and I spent so much time in building. I would have no resources to fight for my own right to practice, as allowed by the Constitution.

My attorney filed papers with the court to stop the IRS from pursuing the collection activities and a very short time later filed for motion for summary judgment on the section 530 issue. The court ruled on the summary judgment motion and held, not only was my company qualified under section 530 protection, but it qualified based on three separate reasonable bases; namely, a reasonable reliance on judicial precedent, a reasonable reliance on Revenue Ruling 61–196, and a reasonable reliance on a reasonable interpretation of the common law test.

I am fortunate that my company had the financial resources available to defend me against the IRS attack on my business. The fact that the IRS would not accept the section 530 defense where the court had held that my company was eligible on three separate bases, and the fact that I almost lost my business as a consequence of the IRS' aggressive collection effort to collect the taxes that the court held my company did not owe, it is unconscionable.

Although I understand it is difficult to attain attorney fees under the current interpretation of the tax bill of rights, when my attorney filed for attorney fees, the government never contested. I received a check from the government several weeks ago. The government check did not cover the fees that occurred, however, but the

cost was over \$10,000 more than I received.

This \$10,000 that the government had to write—did not have the right to take from me. More important than the money, however, the government had no right to put my wife through the many months of long nightmare, living in daily fear of losing our business, when we did nothing wrong.

As a law-abiding taxpayer who had built a significant business that provided a lot of opportunities for entrepreneur nurses, I to this day cannot fathom why the IRS expended so much effort to drive me out of business. It just does not make any sense to me.

The reason I testified before this Subcommittee today is to ask for your help in reining in the IRS. Although I have heard a lot of testimony today about the problems of the current law, in my opinion, the current law on the books is just fine. The problem is in the enforcement by the IRS. If nothing is done to change the IRS' enforcement, then changing the law will not make any difference.

The court held that under current law my case was clear. I won on three separate reasonable tax bases. This does not stop the IRS from making me go to court to win. I do not understand why one would think that a change in the law would protect taxpayers from having to go through the hell that my wife and I had to go through when this case could hardly be clearer than mine was.

In my opinion, the Congress needs to enact a law that stops the IRS from acting as predators on small businesses. Under the notorious ETEP programs, the IRS has focused its attack on small businesses who, I guess, the IRS assumes cannot afford to fight back. Through intimidation and aggressive collections, the IRS seeks to coerce those businesses to reclassify workers as employee status, with complete disregard for why the worker was actually classified correctly. These practices need to be stopped now.

What I think is needed is a modification of the tax bill rights fee recovery provision that would make it easier for taxpayers to be eligible to recover fees in cases where the taxpayer is held eligible under section 530 protection. Furthermore, in those cases taxpayers must be made whole. The law should provide that in cases like mine the government is required to bear the total cost of defending against an unjustified IRS attack, not just a portion.

Although I know the Subcommittee considered a proposal that will significantly change the test of independent contractor status, I am not certain whether that is a good approach at this time.

As I indicated earlier, I do not believe there is any problem with the law. Current and new law only add further confusion, and after reviewing a copy of the bill, I am not sure whether my company would qualify, because it would depend on how certain terms of the bill were defined. If the IRS is allowed to define the terms, my guess is that my company would probably not qualify.

The greatest concern I have with the bill is whether its enact-

ment might involve some tradeoff that affects section 530.

My wife and I have spent what is, to us, a great deal of money to endure many sleepless nights and finally to obtain some certainty for my company. I do not think it is worth jeopardizing current law, particularly section 530, as a tradeoff pursuing a new law that presents some of the same type of uncertain terms and definitions that earlier witnesses have explained about under current law. In my view, this is especially so when, based on my experience, the real problem seems to be with the agency that enforces these laws, the IRS. Unless IRS enforcement strategies are changed, I do not believe it makes any difference what the law is.

Thank you for the privilege to testify this morning, and I am sorry I went over time, but thank you so much for your indulgence.

[The prepared statement follows:]

STATEMENT OF DAVID BARBEE OF HOSPITAL RESOURCE PERSONNEL, INC.

SUBCOMMITTEE ON OVERSIGHT COMMITTEE ON WAYS AND MEANS UNITED STATES HOUSE OF REPRESENTATIVES

June 4, 1996

Madam Chairman and Members of the Subcommittee:

My name is David Barbee. I am President of Hospital Resource Personnel, Inc., a nurse referral agency based in Augusta, Georgia. I am also an Advisory Board Member of the Independent Contractor Association of America, Inc. (the "ICAA").

My company's business consists of referring self-employed independent contractor nurses to perform services for hospitals and other institutions that have a peak demand for nurses. We refer only state-licensed nurses, and do not provide any training or instructions concerning the services they perform for clients.

The ICAA is a national association dedicated to the preservation of independent contractor status. ICAA members consist of individuals working as independent contractors and businesses that purchase services from independent contractors. ICAA currently represents over 3,000 independent contractors and businesses that engage independent contractors.

Although I am generally supportive of the objectives of the independent contractor reform legislation introduced by Representative Christensen (R-Neb) and the similar bill introduced in the Senate by Senators Nickles (R-Okla) and Bond (R-Mo), I nonetheless, urge the Congress to proceed with caution and careful deliberation before enacting any legislation that would affect the definition of independent contractor status.

I agree with the proponents of the pending independe. contractor reform legislation that the Internal Revenue Service ("IRS") construes the tax laws that distinguish between employees and independent contractors unfairly, with an overemphasis on converting independent contractors — whether bona fide or not — to employee status. The fact that the IRS would include as part of its Employment Tax Examination Program ("ETEP") a component that targets for worker classification challenges businesses with assets of less than \$3 million (who are least financially able to defend against IRS challenges) is utterly unjustifiable.

The basic problem, however, is one of enforcement, not the law.

In my particular case, the court held that under current law, my company's classification of workers as independent contractors qualified for protection under Section 530 of the Revenue Act of 1978 — based on three separate and independent "reasonable bases," namely, reasonable reliance on a judicial decision, reasonable reliance on a revenue ruling and reasonable reliance on the common law test.

To be sure, it is difficult to imagine how a case could be more clear than mine under *any* law. Notwithstanding the clear application of Section 530 to my case, however, the IRS forced me to bear the financial risk of going to court in order to continue classifying workers as independent contractors.

My case demonstrates that a good law can be made to look bad if the law is subject to perverse enforcement.

I submit that although the pending legislation to establish a new safe harbor provision has been helpful in sensitizing the IRS national office to the harsh treatment that taxpayers are

receiving at the hands of overzealous IRS agents, I am not sure whether the enactment of such a law would actually accomplish much for small business taxpavers.

My case did not arise out of an uncertain application of the law, it arose out of the IRS seeking to coerce my business into reclassifying workers to employee status irrespective of the law. Consequently, I believe that any independent contractor reform should focus on the IRS. The IRS's attack on small businesses that use independent contractors must be stopped.

A starting point for modifying the IRS's enforcement philosophy with respect to small businesses that engage independent contractors would be:

to enact a provision that would allow a small business taxpayer that (1) explains to the IRS
in writing why it is eligible for Section 530 protection, and (2) is held by a court to qualify
for Section 530, to recover from the government all the costs incurred in defending against
the IRS challenge.

A fee recovery provision along these lines would provide small business taxpayers with the certainty they need to vigorously defend against IRS challenges to their classification of workers as independent contractors when they are confident that their classification is protected under Section 530.

One of the reasons for going slow with any new legislation affecting the definition of employee or independent contractor is that certain aspects of current law are for many taxpayers—including me—sacrosanct. My concern with any law that would affect the determination of a worker's status for federal tax purposes is attributable in part to the fact that the legislative process can be unpredictable. In other words, the law that is introduced might not be the same as the law ultimately enacted. What is more, if the proposed law is determined to cause a loss of tax revenues to the federal government, I am concerned about the type of revenue-raising provision that might be combined with the bill to offset its revenue loss.

Consequently, I respectfully urge the Congress, in its consideration of legislation affecting independent contractor status, to ensure that:

- The protection currently provided under Section 530 not be displaced;
- The other statutory independent contractor provisions be preserved;
- The 20-factor common law test for determining independent contractor status remain as the "fall-back" test for workers who do not satisfy a safe harbor test; and
- If the proposal results in a revenue loss to the government, the proposal not be "paid for" by
 imposing withholding mandatory or optional on payments made to independent
 contractors.

If substantive change is deemed essential, the change in my opinion should be minor. An appropriate change in the definitional rules at this juncture should build on current law. I submit that the Congress should consider fine-tuning Section 530 in a way that would limit the IRS's ability to seek to impose on taxpayers strained interpretations of Section 530. Fine-tuning changes might include:

 Imposing a de minimis exception to the consistency requirement of Section 530, and requiring the consistency requirement to be met only with respect to the three consecutive years next preceding the year at issue; and

Recent developments at the IRS — that arguably resulted from the pending legislation — include (1) a set of draft Training Guidelines for IRS agents concerning the independent contractor issue, (2) Announcement 96-13, which allows certain employment tax issues, including worker classification disputes, to be eligible for an early referral during audit for IRS Appeals consideration, and (3) an IRS Fact sheet that announced a new worker classification settlement program ("CSP") that might be advantageous to some businesses.

 Defining by statute the percentage of an industry that constitutes a "significant segment" for purposes of the industry practice safe harbor of Section 530.

According to the Small Business Administration, there are five million independent contractors in America. Almost one-third of all companies use independent contractors to some degree. Independent contractor status gives both service providers and service recipients the flexibility needed to be competitive in today's economic environment. It is submitted that the fact that so many independent contractors currently exist demonstrates that the existing laws, while perhaps not perfect, are not altogether flawed.

Liberalize Fee Recovery Provision For Small Businesses that Qualify for Section 530 Protection

Currently, a taxpayer must show that the IRS's position is not substantially justified in order to qualify for reimbursement of the attorney fees incurred in defending against an IRS challenge to its classification of workers as independent contractors. The only fees that are subject to recovery are those incurred in connection with actual litigation. The provision also imposes a cap on the hourly rate that can be recovered.

Although a proposed revision of the fee recovery provision is contained in legislation that passed the House of Representatives and is pending before the Senate, those provisions would shift the burden of proof to require the IRS to demonstrate that its position in a case in which the taxpayer prevailed was substantially justified. In my judgment, those provisions, while appropriate for many cases, should be expanded for Section 530 cases.

I suggest that a taxpayer that explains to the IRS in writing why it is eligible for protection under Section 530, but is nonetheless forced to litigate the case, d be entitled to recover all its costs incurred in connection with the dispute, provided that the court holds that the taxpayer is eligible for protection under Section 530 based substantially on the rationale that the taxpayer provided the IRS in its written explanation.

Preserve Section 530

Section 530 was enacted in reaction to overzealous efforts by the IRS in seeking reclassifications of workers to employee status. During the past several years, the IRS has been pursuing a worker reclassification program with similar aggression. Many businesses that engage independent contractors currently do so with great fear of having to possibly defend against an IRS worker reclassification challenge in a lengthy — and expensive — court battle. Section 530 provides a valuable refuge for such businesses. Section 530 provides businesses with a means of engaging independent contractors with some degree of security that the IRS will leave them alone. Each of the safe harbors of Section 530 are important for a specific reason.

Reasonable reliance on administrative or judicial precedent is important, because it protects businesses that have sought to properly classify workers based on a good-faith interpretation of applicable precedent. The subjective nature of the common law test in many cases defies a precise conclusion as to a worker's status. This safe harbor is needed, therefore, to enable businesses to enter into business relationships with contractors, based on a reasonable interpretation of case law and certain IRS administrative guidance, without fear that the IRS will later interpret that precedent differently and force the business to litigate the matter in court.

The prior IRS audit safe harbor is also important because it protects businesses from repeated IRS audits, year after year, concerning the same workers. The safe harbor was enacted precisely because the IRS was harassing businesses with recurrent audits concerning the very same workers. The criticism sometimes made about this safe harbor — that it would apply to a business that had been audited by the IRS on an unrelated issue — is simply unfounded. The requirement that reliance on the safe harbor be "reasonable" would prohibit that possibility. To eliminate this valuable safe harbor would subject businesses, once again, to repeated harassment by the IRS concerning workers who the IRS has previously determined to be properly classified.

Under current law, the taxpayer must demonstrate that the government's position was not substantially justified.

The industry practice safe harbor is a critical safe harbor for those industries where a type of worker had always been classified as an independent contractor, but no administrative or judicial precedent has been established to confirm the appropriateness of that classification. It is submitted that where an industry practice has been followed year after year with respect to the classification of a type of worker, there is no plausible rationale for disrupting that practice especially when the compensation paid such workers is reported on Forms 1099, as Section 530 requires.

The "other reasonable basis" safe harbor is valuable to those businesses that have a reasonable basis for classifying workers as independent contractors but do not qualify for one of the statutorily-prescribed safe harbors. Courts have provided a constrained interpretation of this safe harbor, and current law in this area should not be disturbed.

Overall, Section 530 provides a safe haven protection to businesses that, since the law's enactment, have assiduously complied with its requirements. Tens of thousands of business arrangements have been structured in reliance on Section 530. To abandon any of the safe havens offered under Section 530 would significantly disrupt the market for freelance talent, and produce no offsetting benefit. The Form 1099 requirement contained in Section 530 already requires that the compensation paid an independent contractor that is covered by Section 530 be reported to both the worker and the government. Thus, there would be no revenue gain to be derived from such a disruptive action (actually there would likely be a revenue loss as a consequence of existing business relationships that produce taxable income being severed).

Section 530 was enacted to stop repeated audits and ensure fairness. The fairness established by Section 530 should not be eliminated.

For the foregoing reasons, I strongly urge the Congress, in its consideration of alternative proposals to reform the independent contractor laws, to not disturb the protection currently provided under Section 530.

Retain the Common Law Test

No matter what the Congress decides with respect to the establishment of additional safe harbor protection for independent contractor status, it is submitted that the common law test *must* be preserved for those workers who might not qualify for a safe harbor.

The nation's economy is dynamic and unpredictable. Individuals are currently providing services that merely a decade ago could not have been fathomed. Thus, while a safe harbor could be devised that covers all types of services that are provided in today's economy, there is simply no way to ascertain whether the safe harbor would also cover new types of services that might be performed five years from now, or even two or three years hence. For this reason, the common law test — as a test of last resort — must remain sacrosanct.

No Withholding

Proposals have been offered to impose withholding on payments made to independent contractors. The proposals have been offered either as a "trade-off" for certainty in a worker's independent contractor status, or as a means to "pay for" the revenue loss that would be attributable to a proposal that modifies the worker classification rules in a way favorable to independent contractors.

I submit that any withholding proposal — mandatory or optional — would be devastating to the viability of independent contractor status.

To single out the independent contractor sole proprietorship for withholding — while exempting other forms of business — would place independent contractors at an unfair disadvantage relative to their competition. Current law recognizes several forms of business, e.g., corporation, partnership, proprietorship, LLC and LLP. A company that contracts with a firm to provide services currently has no duty to withhold on the fees paid the firm, irrespective of the

form of entity through which the firm operates. To single out proprietorships for imposing withholding would impede their ability to attract and retain clients, inasmuch as the clients and potential clients of a proprietorship subject to withholding would be burdened with administrative withholding duties that they would avoid by contracting instead with the proprietorship's competitors that operate through a different form of business.

Furthermore, to impose withholding on payments made to independent contractors would create competitive imbalances within and among industries. The actual financial impact on a business of, for example, a 5-percent withholding rate would depend on the business's net profit as a percentage of gross revenues. A business with a net profit margin of 10 percent of gross revenues would be much more affected by 5 percent being withheld from their fees than a business with a net profit margin of 50 percent of gross revenues. In the former case, the government would be withholding 50 percent of net income for the year (5% / 10%), whereas in the second case the government would be withholding 10 percent (5% / 50%). Such variances of net income as a percentage of gross revenues exist both within and among industries.

The reason why withholding is not problematic as applied to employees is that an employee's net income from a job is generally equal to or very near 100 percent of wages paid. Employees are not required, for example, to advertise their services, to purchase the equipment and supplies needed to perform their services or to pay the expenses otherwise incurred in running a business. Their employer assumes those burdens. And, their employer is not subject to withholding with respect to its revenues.

For the foregoing reasons, I urge the Congress to remain steadfast against any effort to impose withholding in any form on payments made to independent contractors.

Modify Consistency Requirement of Section 530

A common argument made against Section 530 is that it creates unfair competitive distinctions between businesses that are eligible for Section 530 — who are free from harassment by the IRS, and those that are not eligible — who remain vulnerable to recurring IRS challenges to their classification of workers as independent contractors.

One of the most onerous and unforgiving requirements of Section 530 is its consistency requirement — which requires that a taxpayer always classify all substantially similar workers as independent contractors. A company that has treated one type of worker as an employee is forever precluded from obtaining Section 530 protection with respect to that type of worker.

Although the objective of the consistency requirement is meritorious, its application in some cases can produce harsh and undesirable outcomes. For example, consider two businesses, one started during 1980 and the other in 1990. The business started in 1980 was a pioneer in its industry and originally classified a certain type of worker as employees, but almost immediately converted them to independent contractor status. The other business started in 1990 and classifies its work force the same as the first business currently does.

In this scenario, the pioneer business that effectively showed the rest of its industry that a certain type of worker is more suitably classified as independent contractors would be precluded from ever obtaining protection under Section 530 with respect to those workers. Its competitors, however — that emulated its business structure and that learned from its early mistakes — can qualify for Section 530 protection.

It is submitted that such a result is unjust. It is further submitted that the inequitable result just described could be avoided if the consistency requirement were modified so that it did not operate as an absolute perennial bar.

We urge the Congress to consider modifying the consistency requirement so that:

· A de minimis violation of the requirement not be taken into account, and

 A taxpayer that violates the requirement not be forever barred from eligibility, but only be deemed ineligible for a specified period of time, such as three years. After the expiration of the specified period of time, the earlier violation would be disregarded.

These suggested modifications of the consistency requirement are minor, and they would preserve the general objective of the requirement by requiring consistent treatment of substantially similar workers. At the same time, however, the suggested modifications would eliminate the perceived competitive imbalances that can be created by Section 530.

Clarify Industry Practice Safe Harbor

A frequently litigated issue involving the industry practice safe harbor provision of Section 530 involves determining what percentage of an industry constitutes a significant segment of the industry. Although IRS Commissioner Margaret Richardson confirmed in a letter to Subcommittee Chairman Nancy Johnson (R-Ct) that the IRS does not interpret the term as requiring between 65 and 90 percent, that letter has not been accorded appropriate deference by IRS representatives in "the field."

It is submitted that the controversy over this issue has created needless uncertainty for taxpayers and should be resolved. The means for resolution is apparent; the Congress should specify by statute a minimum percentage that is deemed to constitute a significant segment.

Conclusion

For the foregoing reasons, I respectfully urge the Congress to approach new legislative proposals for addressing the perennial issue of worker classification cautiously, and that protections that are contained under current law not be sacrificed as a price to be paid for a new approach.

I appreciate the opportunity to present this statement and to testify today. If you have any questions or would like additional information concerning the foregoing comments, please let me know.

Respectfully submitted,

David Barbee President, Hospital Resource Personnel, Inc. Advisory Board Member, ICAA Chairman JOHNSON. Thank you so much for sharing your testimony with us. I appreciate that the witnesses have come from some distance to be here, and I appreciate your thoughts.

Mr. Kessler.

STATEMENT OF WAYNE KESSLER, PRESIDENT, LDW, INC., BENSALEM, PENNSYLVANIA

Mr. KESSLER. Thank you.

My name is Wayne Kessler, and I am president of LDW, Inc. I want to thank all of you for the opportunity to address an issue that has been described by the business community as the single

most important problem for small business.

There are only two things you can do when the heavy hand of government places their regulatory mitts on your shoulders; fight or capitulate. I and several others decided to fight. I knew my decision to fight City Hall would be a long, lonely, and costly battle, but I believed in my cause and hoped that somewhere in our government my voice would be heard. Today is that day.

My company, LDW, Inc., located in Bensalem, Pennsylvania, was founded 15 years ago after the company I was employed with closed. I was 38 years old at the time and decided to strike out on my own. With about \$3,000 in my hand, hard work, and a belief that opportunities abound in this country, I took my shot and have

had many successful years as a small business owner.

As part of our normal course of business, LDW contracts with many other small businessmen and women to service the cable television industry, constructing and installing the cable services that we all enjoy in our homes today. In so doing, I feel that I accomplish something for the community, the subcontractors, and for my family.

When I started the business, I believed that I could be successful. I believed in myself and my country. This is America, the land of

opportunity for those with a little luck and a little moxie.

In 1989, LDW was audited by the IRS, during which time the use of our independent contractors was examined. At the conclusion of the investigation, the IRS informed us that no change was necessary in our reported taxes or our business operation.

During the audit, the IRS agent carefully scrutinized our use of subcontractors. The agent checked all the pertinent facts—contracts, invoicing, training, historical treatment of the workers, and so on. As far as the auditors were concerned, we were conducting

our business in a proper manner.

Last year, we were notified by the IRS that LDW was going to be audited once again. We were told that there was a special project within the IRS targeting the cable installation industry. Unfortunately, our encounters with IRS auditors this time have resulted in threats and intimidation.

During this audit, we were advised that our use of independent contractors was in error, although our business practices and use of the independent contractors remained unchanged since the 1989 audit when we were given a clean bill of health. However, we were told that a prior audit could easily be overturned. In addition, the auditor did not consider industrywide practice or legal precedent as claim to section 530 relief.

We have asked the IRS, under the Freedom of Information Act, to give us the working papers of the 1989 audit. We requested this information in September 1995, and the IRS has yet to supply the documents. In the meantime, however, the IRS auditor wants to deny LDW section 530 relief.

We have the letter that the IRS sent to us at the conclusion of the 1989 audit indicating we were indeed operating appropriately. However, this does not seem to be enough for them either. It is clear the IRS is treating their previous finding of "no change" as

irrelevant and incorrect.

In May, 1996, LDW was notified by the IRS auditor that they would like us to settle the matter of claims against LDW. I am not certain at this time what the specific details of the settlement would involve. However, it seems clear that the IRS wants LDW to comply with vague guidelines that most certainly will be rewritten.

Nothing has changed in our mode of operation since 1989, much less since the company was started, either within the industry or the IRS guidelines, that would warrant reclassification or substantiate treating the previous IRS findings as incorrect.

If we continue to fight the IRS' arbitrary and capricious demands, hefty assessments will be levied against us which will put LDW out of business. This is particularly egregious because the IRS has already determined in a previous audit that our contractors are independent and not employees. I am in the unenviable position of being regulated out of business this year and legislated back into business next year, an impossibility for me.

If this is allowed to happen, what message are we sending the small business community and entrepreneurs who, through sweat and hard work, have created many jobs and helped people build their lives and their communities? To paraphrase Mr. Wilson, what

is good for small business is good for America.

Thank you for your time, and I will be happy to answer any questions that you may have.

[The prepared statement follows:]

TESTIMONY OF WAYNE KESSLER PRESIDENT LDW, INC.

BEFORE THE SUBCOMMITTEE ON OVERSIGHT COMMITTEE ON WAYS AND MEANS

UNITED STATES HOUSE OF REPRESENTATIVES

JUNE 4, 1996

I want to thank all of you for the opportunity to address an issue that has been described by the business community as the single most important problem for small business.

There are only two things you can do when the heavy hand of the government places their regulatory mitts on your shoulder, fight or capitulate. I and several others decided to fight.

I knew my decision to fight "City Hall" would be a long, lonely and costly battle, but I believed in my cause and hoped that somewhere in our government my voice would be heard.

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As part of our normal course of business, LDW contracts with many other small businessmen and women to service the cable television industry constructing and installing the cable services that we all enjoy in our homes today. In so doing, I feel that I accomplish something for the community, the subcontractors, and for my family. When I started the business I really believed that I could be successful. I believed in myself and my country. This is America, a land of opportunity for those with a little luck and a little moxie.

In 1989, LDW was audited by the IRS during which time our use of independent contractors was examined. At the conclusion of the investigation, the IRS informed us that no change was necessary in our reported taxes or our business operation. During the audit, the IRS agent carefully scrutinized our use of subcontractors. The agent checked all the pertinent facts - contracts, invoicing, training, historical treatment of the workers and so on. As far as the auditors were concerned we were conducting our business in a proper manner.

Last year, we were notified by the IRS that LDW was going to be audited once again. We were told that there was an "unofficial" special project within the IRS targeting the cable installation industry. Unfortunately, our encounters with the IRS auditors this time around have resulted in threats and intimidation. During this audit, we were advised that our use of independent contractors was in error, although our business practices and use of independent contractors remained unchanged since the 1989 audit - when we were essentially given a clean bill of health. However, we were told that a prior audit could easily be overturned.

In addition, the auditor did not even consider industry-wide practice or historical precedent as claim to Section 530 relief. We have asked the IRS, under the Freedom of Information Act, to give us the working papers of the 1989 audit. We requested this information at the beginning of this year and the IRS has yet to comply. In the meantime, however, an IRS auditor wants to deny

LDW Section 530 relief. We have the letter that the IRS sent to us at the conclusion of the 1989 audit indicating we were indeed operating appropriately, however, this does not seem to be enough for the them. It is clear the IRS is treating their previous findings of "no change" as irrelevant and incorrect.

Earlier this month, LDW was notified by the IRS auditor that they would like us to settle the matter of claims against LDW. I am not certain at this time what the specific details of the settlement would involve, however, it seems clear that the IRS wants LDW to comply with vague guidelines that most certainly will be rewritten. Nothing has changed in our mode of operation since 1989, much less since the company was started, either within the industry or in IRS guidelines, that would warrant reclassification or substantiate treating the previous IRS findings as incorrect. If we continue to fight the IRS' arbitrary and capricious demands, hefty assessments will be levied against us, which will put LDW out of business. This is particularly egregious because the IRS has already determined in a previous audit that our contractors are independent and not employees. I am in the unenviable position of being regulated out of business this year and being legislated back into business next year, an impossibility for me.

If this is allowed to happen, what message are we sending to the small business community and the entrepreneurs who, through sweat and hard work, have created many jobs and helped people to build their lives and their communities? To paraphrase Mr. Wilson, "What's good for small business is good for America."

Thank you for your time. I would be happy to answer any questions that you might have.

Chairman JOHNSON. Thank you, Mr. Kessler, for sharing your experience with us.

Mr. Bolt.

STATEMENT OF MIKE MCCARTY, PRESIDENT, DC WIRING, INC.; AS PRESENTED BY DAVID BOLT, VICE PRESIDENT, DC WIR-ING, INC., SWEDESBORO, NEW JERSEY

Mr. Bolt. Madam Chairman.

Chairman JOHNSON. Before you begin, I would like to express my condolences to Mr. McCarthy. I regret he cannot be here with us, and I am pleased you are with us.

Please proceed.

Mr. Bolt. My name is David Bolt, vice president of DC Wiring. I am appearing here-

Chairman JOHNSON. If you could get a little closer to the micro-

phone, we can hear better. Thank you.

Mr. Bolt. I am appearing here today substituting for the president of our company, Mike McCarthy. Mr. McCarthy very much wanted to be here to deliver his testimony. Unfortunately, his mother passed away and he is attending her funeral. He asked me to appear today and read his testimony.

I appreciate the opportunity to testify about my experience in dealing with the worker classification issue. Unfortunately, my experience has been one of great adversity, involving years of burdensome accusations and costly legal bills. I am at the point now where I will lose my business imminently if something is not done to curb the erratic and unfair application of the worker classification standard.

By way of background, in our business, cable TV operators contract with companies such as mine, otherwise known as cable installation-related services companies, to obtain installers for the installation services to the customer. Cable installation-related services companies, in turn, contract with independent contractors, who use their own transportation, tools, and techniques to perform the cable installation.

Mike and I met while we were independent contractors doing work for another larger cable installation company 16 years ago. Ironically, our former company has not been targeted by the IRS or the Department of Labor. We both dreamed, as young boys, of one day owning our own business. That dream became a reality 11

years ago when we started DC Wiring.

It was a real struggle the first 5 years, but finally we felt we had faced every obstacle imaginable and that we were on our way. Then we received a visit from the IRS and the U.S. Department of Labor. From then until now, the pressure has been unrelenting, both emotionally and financially. We have seriously considered closing our doors on more than one occasion. Instead, we have decided to fight to change the unfairness and unwieldiness of the worker classification issue, not only for ourselves, but for other small businesses that have come under IRS scrutiny.

Cable installation-related services companies have used independent contractors since the inception of this industry more than 40 years ago. For the IRS to now arbitrarily decide that some workers are independent contractors while others are employees is unfair and absurd. The industry has operated the same way since 1952.

The vast majority of companies in the industry, including broadcast companies, utilize independent contractors to perform the actual cable installation. The IRS is concerned that they are not collecting all of the taxes due them and is making American small businesses and workers suffer the consequences.

Big government should not be making small business a tax collector and, in so doing, putting small business out of business and workers on the street. We understand the need for the IRS to collect tax revenue. However, this is not a reason to force small businesses to become tax collectors.

It is important to understand that this is not a situation where we are reclassifying workers from employees to independent contractors. They have always been independent contractors, and now, at great economic cost to us and other companies and contractors, the IRS and the U.S. Department of Labor want them classified as employees.

In the cable industry, independent contractors provide the necessary skills and expertise to complete the installation in an efficient and timely manner. The flexibility provided by an independent contractor offers numerous advantages for the cable TV company, the cable installation-related services company, and the independent contractor. It is imperative that a businessowner have the opportunity to make sound economic decisions in the operation of their company.

Because independent contractors play a vital role in the industry, clarification of the standards that determine this status is critical. There is an overwhelming consensus that the IRS' 20-factor test, a common law test for determining worker classification, is a whimsical and completely subjective process. The uncertainty surrounding the test leads to litigation and large assessments levied against businesses, like mine, that are devastating, if not fatal. These assessments are unjust and accomplish nothing.

It is unreasonable that an industry which has been conducting business for more than 40 years now be told that its business practices are inappropriate and that it is subject to hefty retroactive assessments. This is entirely unfair and causes substantial economic drain.

These assessments and the costs associated with defending such erratic decisions will force DC Wiring out of business. This will have a profound effect not only on me and my family, but also on office employees, their families, and the community as a whole.

It is also important to note that classifying workers as employees or contractors affects more than just one government entity. If the IRS classifies certain workers as employees, for all intents and purposes, other government agencies will need to do so as well. That includes the U.S. Department of Labor and State agencies. This is a never-ending cycle, and we need some clarification of this issue.

I thank the Subcommittee for inviting me here today, and I urge you to take quick action to resolve this important issue.

Chairman JOHNSON. Thank you very much, Mr. Bolt.

Mr. Gee, my colleague and friend, Rep. John Duncan, mentioned to me last week that you were going to be joining us, and it is a pleasure to have you.

STATEMENT OF EDGAR H. GEE, JR., CERTIFIED PUBLIC ACCOUNTANT, KNOXVILLE, TENNESSEE

Mr. GEE. Thank you very much.

My name is Edgar Gee. I am a CPA from Knoxville, Tennessee. It is an honor and a privilege for me to be here. I appreciate this opportunity.

I am a member of the AICPA and TSCPA. I have had my own practice for about 20 years. I am here today to speak with you about the reality of dealing with the independent contractor issue firsthand.

Beginning in December 1991, the IRS initiated an examination of a client of mine on this issue. My client was Smoky Mountain Secrets. This took place in the Eastern District of the Federal District Court of Tennessee. You have an opinion attached to that. I was the initial and primary witness in this case.

The court handed down its opinion September 29, 1995, about three and a half years later, and ruled in favor of my client, and it saved my client \$4 million. I believe that ruling makes this case one of the largest independent contractor cases in the history of the country.

It is significant that this particular case is the first case litigated under code section 3508 and code section 530, and we prevailed in both of these code sections. I think paragraph 16—page 16, paragraph 9, of the court's opinion is particularly relevant because it did away with any possibility of appeal the Service might have, and we have a petition for fees pending in court at this time.

The rest of what I wanted to tell you today is what happened in the case. We asked the IRS at every level—the agent level, the agent supervisor level, the appeals conferee level, the district counsel level, and the Justice Department level—to simply answer these questions: What part of the section 3508 did they think we did not meet? Even if we didn't meet section 3508, how did they possibly think we didn't meet section 530?

We never got an answer from the government ever, and in fact at trial the government presented no witnesses and no evidence at all.

The rest of what I am going to tell you here today I am telling you because I think you, as Members of the Committee, need to know what took place in this case.

In the spring of 1993, I got a call from the employment tax specialists in Chattanooga, the gentleman and I met for lunch in Knoxville, during which he told me that his solution for resolving this case was a prospective reclassification of all of my client's people that were working for them.

I asked him why did he think I would consider doing that. He indicated that if we did not do it, they were going to sue us and make us litigate the case.

I indicated to him that it sounded a little bit like blackmail and extortion to me. He said call it whatever you want, but he said they

treated everybody this way. I asked him who in the world tells him to do things like this. He said the national office instructs him.

I made a comment to him that I knew he had seen the case file and I said, "You have to know we have a very strong case." He said, "You have a very strong case. You are going to win if you go to court. We already know that."

Sometime after that, I obtained some internal IRS documents under the Freedom of Information Act, and they are attached to my report that you have. Those documents clearly show that as early as 1992 the government was actually writing memos to each other indicating that they knew they had no case. I have some suggestions that I think that we need to consider.

Chairman JOHNSON. Excuse me, Mr. Gee. Did I understand you clearly that you have copies of memos that the IRS wrote showing that they knew they had no case?

Mr. GEE. Yes, ma'am. They are attached to my remarks. Chairman JOHNSON. They are attached to your remarks.

Mr. GEE. Internal memos that I got under the Freedom of Information Act.

Chairman JOHNSON. Thank you.

Mr. GEE. In concluding, let me say this. I do have some solution here. Taxpayers need to be issued 1099s and they need to have written contracts. But the bottom line is this: My client should never have had to spend a dime having to litigate this case. Second, no taxpayer or citizen should ever be subjected to this kind of abuse at the hand of the Internal Revenue Service.

I thank you for letting me be here today, and I will answer any questions you have.

Thank you very much.

[The prepared statement and attachments follow:]

STATEMENT OF EDGER H. GEE, JR., CPA, MBA

I. INTRODUCTION

My name is Edgar H. Gee, Jr. and I am a CPA from Knoxville, Tennessee. It is an honor and a privilege for me to address this committee today and I appreciate this opportunity. I am a member of the AICPA and TSCPA and I have had my own practice for 20 years.

I am here today to speak to you about the Internal Revenue Service and the continuing controversy relating to independent contractors. I am speaking from my own experience - the reality of dealing with this firsthand.

II. THE CASE

Beginning in December 1991, the IRS initiated an examination of a client of mine which involved the issue of employees v independent contractors. This issue culminated on July 20, 1995 when the case was tried in Federal Court - the Eastern District of Tennessee. (Court opinion attached)

I was the initial and primary witness in the case, representing my client Smoky Mountain Secrets, Inc., headquartered in Alcoa, Tn.

The Court handed down its opinion on September 29, 1995. With the Court's opinion in my clients favor and against the government, we prevailed in what I believe is the largest independent contractor case litigated in the history of the United States. This saved my client almost four (4) million dollars for years 1989 and 1990 - the two years under examination. Had we lost the case, there were open years where the taxes assessed by the IRS would have tripled this amount making it somewhere between a \$15 - \$20 million case

This appears to be the first case ever litigated involving both IRC Sec 3508(TEFRA '82) - the direct sellers exemption and Revenue Act '78 Section 530, the safe harbor relief provisions. As you can see from the court's opinion on page 16, paragraph 9, we prevailed under **BOTH** sections

This ended any reasonable possibility the Service had for an appeal. This paragraph also provided a basis for our petition to the court for recovery of attorney fees and other costs related to this litigation. This petition is pending in Federal District Court.

III. IRS ACTIONS

The rest of what I am going to tell you all here today are not the observations of some disinterested third party. They are not what I think happened. They are in fact what did happen.

From the revenue agent level, to the agent's manager, to district chiefs, to appeals conferee, to IRS district counsel, to the Department of Justice's lawyer, we could never get an answer to two (2) basic questions. Those simple questions were.

- 1. What part of IRC Sec 3508 did the government think my client did not meet?
- And most importantly even if we did not meet IRC Sec 3508 how could the government even begin to think we did not meet Sec 530?

In fact, there never was an answer ever from the government (even at trial the government presented no evidence and called no witnesses). This amounts to institutional breakdown at each and every level in the existing system and cries out for major change in the way these cases are handled. If the IRS has been willing to focus on these questions at any level, both the taxpayer and the Government would have been spared years of litigation and thousands of dollars in fees and costs.

What I am going to tell you next, I am going to tell you out of a sense of duty because the members of this committee need to know what transpired in this case. Hopefully this will help this committee to develop legislation which will prevent such institutional breakdowns in the future. I believe that is in the best interest of both the Government and its taxpayers

While this case was before the appeals conferee in Nashville, I received a phone call from the districts chief employment tax specialist. He told me he had a way to resolve this case. He said he wanted to come up to Knoxville and meet with me. I arranged for lunch at Regas Restaurant in Knoxville.

His solution to resolve the case was for my client to reclassify his independent contractors to employees on a prospective basis and he said IRS would drop the case if we did that. I asked why did he think I would even consider this proposal of his? His response was if we didn't agree, the Service was going to sue us and make us litigate the case. I said but you have seen the case file. You have to know I have a strong case. His response was that we did have a strong case and were probably going to win anyway if we went to court. I was incredulous. I said who in the world tells you all to do this - to conduct a case this way - to cause taxpayers to be put to this expense even though the Government expects to lose? His response was National Office.

At this point I realized the utter futility of continuing any dialogue and that court was the only logical alternative. Some months after this luncheon, I discovered (under the Freedom of Information Act) internal IRS memos written in late 1992 (prior to this Regas luncheon meeting) where the IRS memos actually stated that "...the Government would have absolutely no case." (Exhibits attached).

IV. SUGGESTED CHANGES OR STRONG RECOMMENDATIONS

- A) IRS should undertake a comprehensive training program to insure that all IRS employees who deal with this problem in any manner understand the laws and intent of the Congress.
 - B) Have these simple rules:
 - a. If Taxpayer
 - Issues 1099's
 - 2. Has written IC contracts
 - 3. Uses performance based pay (e.g. commission per each etc.)
 - b. Then IC status is automatic and not subject to any IRS whim.
 - C) Failing both A and B change the law so that IC status will be respected if 10% is withheld by the payor at the source much like backup withholding now done on pensions, bank interest, etc. In addition, there would be a provision prohibiting businesses form engaging to reclassify former current employees as IC's.
 - D) As the WHCSB recommends, set up a task force or joint committee of one CPA, one tax lawyer, one small businessperson and two (2) members of your subcommittee to review cases like this and initiate legislation to effect changes.
 - E) If the IRS pursues a case like this and loses, give the courts authority to make the award of attorney fees and costs to the taxpayer effective beginning at the agent level and make the award automatic and mandatory. This will stop the IRS 's relentless blind pursuit of these type cases.

V. CONCLUSION

Ladies and gentlemen the bottom line is this My client should never have had to spend the first dime on this case. No taxpayer should ever again be subjected to this kind of abuse at the hands of an agency of the Federal Government.

Thank you. I will be happy to answer any questions which members of the Committee might wish to ask.



Internal Revenue Service MEMORANDUM

date: Nevember 24, 1992

to: Gene Boon, Group Hgr 1318

from: Sary Watkins, Employment Tex Specialist

subject: Employment Tax Case

Per your raquest, I have reviewed the Revenue Agents Report as well as the Protest submitted by the Corporations POA. It would appear that the Tempayer is relying on essentially two avenues in which to defeat the Agents initial determination. The first defense presented, is that of the workers meating the criteria of statutory non-manulouses under the category of Direct Sellers. The POA states that the workers "..meat both criteria in subsection 2(A) when they could meet aither or and still fit under the addition." The criteria being described is that of IRC Section 3580(b)(2)(A). It states that the term "direct seller" means any person who!

- (1) "is engaged in the trade or business of selling (or soliciting the sale of) consumer products to any buyer on a buyers! basis, a deposite-commission basis, or any similar basis which the Secretary prescribes by regulations, for resale (by the buyer or any other person) in the home or sinerwise than in a paragent retail satablishment, or
- (11) "Is engaged in the trade or business of selling (or soliciting the sale of) consumer products in the hors or otherwise than in a perpanent retail establishment."

The prevailing question would clearly be, do talephone solicitors working under what would appear to be direct and immediate supervision, in an office complex, quelify as direct sellers under this Section. The answer to that question would be no. The intent of Congress in defining direct sellers as statutory non-employees was to ensure that deem-tendoor, percento-person sellers such as individuals working for such companies as Fuller Brush, Avon, Mary Kay, etc. would not be challenged as to the common law criteria of an employee. In the present case, the telephone solicitors perform their duties in an established office location and not at the home of potential sustoners or some other location in which the custoner would be required to travel to. Therefore, since the telephone solicitors could not be properly classified as direct sellers, one must now look at the common law factors to determine if an employer-employee relationship does exist. Indeed, the facts would tend to indicate that significant control and direction is being exerted on the telephone solicitors, not only as to the results to be

accomplished but also to the means by which that result is accomplished.

The second defense that is being presented in the Protest centers around the safe havens as established by Section 530. The PON contends that the Corporation has been consistent in its treatment of the workers, i.e. treating them as independent contractors and Issuing them 1898's. He goes on to say that the Corp. has reasonable basis in its treatment of the workers based on the fact that his client "..had been examined (years prior to his incorporation of this business) previously where IRS allowed commission only individuals to be nonemplayees. "If indeed this fact can be substantiated, the Bovernment would have absolutely no case. **Kev. Rul., 85-152 cleerly states a past examination would provide the Taxpayer a "reasonable basis" for its treatment of the workers, and therefore, a safe haven under Section 530. The fact that the past sudits were conducted while the business was a sole proprietorship or other type of entity would be immaterial, assuming the nature of the business remained unchanged. It would seem clear that this statement represents the Sovernments most serious challenge to the employment tax issue.

Par your suggestion, I contacted the POA to obtain more specific information concerning the past IRS examination. The CPA, Edgar See, was extremely vague and very élusive when discussing this particular issue. However, he did say that he would contact his client and attampt to provide further information concerning the past audit. Additionally, I contacted Rudy Broughton, Employment Tax Specialist in Birmingham, he agreed completely with my analysis of the Comporations direct seller defense. I will give you a cell when additional information is received from Mr. See.



44 Manager, Group 1317

Internal Revenue Service MEMORANDUM

date: Nevember 38, 1982

to: Sene Soon, Group Hor 1318

from: Gary Watkins, Employment Tax Specialist

subject: Employment Tax Case

On this date, a discussion was held with Edgar See, CPA, concerning the engoing exployment tax ease being worked by Susen Elnors. He stated that information has been reserved as to the past sudits of entities similar to the one under examination which would qualify his client for Section 530 safe haven treatment under the "past IRS Audit Rule". Affidevits were faxed (see attached) indicating that three different corporations were audited in the 1978's with no challenge being nade as to the sales personal receiving non-employee compensation. The entities which ware audited included (1) Seco, Inc., (2) Theroughbred films, Inc., and (3) Phylben Village, Inc. The corporation entities are currently defunct and no EIN's were available. He was uncertain as to the axes thusiness activities conducted by the entities. However, he did state exphatically that the sales people working for the acorporations performed duties involving direct salling to the public, both on the telephone and person-to-person, and they were paid on a consisten besiz. Mr. Gee maintains that Section 530 makes no atipulation as to "substantial assistantly", but infact the Section merely states that a safe haven is provided where a taxpayer is treated as having satisfied the test by showing reasenable reliance on a past Internal Revenue Service audit.

It should be noted that the court case referred to by the CPA in his protest is the case of <u>Imphart's Nursery & Landacanino. Inc. y. United States</u>, No. 88-4288 (Sin Cir. 2-12-79) 56 A.F.T.R. 2d 98-673. In this particular case the texpayer, operating a nursery and landscepting business, hired landscept workers on a job-by-job basis and treated than as independent contractors. In 1876 the IRS sudited Lamberts 1874 returns and an eventual determination was made that the workers were indeed independent contractors. In 1889, Nr. Lambert started a new business of jamitorial services. He employed the Jamitorial workers are indeed independent contractors. The IRS subsequently sudited them as independent contractors. The IRS subsequently sudited the Corporate returns and determined that the jamitorial workers were employees. The district court megistrate was of the opinion that, as a matter of law, both the landscaps workers and the jamitors were estually employees. However, because the two sats of employees were "substantially similer" in their relationship to Lembert, the

magistrate held that Lambert had reasonably relied on the result of an earlier audit in treating the janitorial workers as independent contractors.

The Services position as to Lambert's Nursery & Landscapino, Inc. supra, is that this case should not be followed in situations where a prior audit has eccurred but the tempeyer has begun a new line of business, and workers (determined to be employees) are performing different services. Indeed, the Services standing position has been that reliance on a past Internal Revenue Service audit would qualify only if the audit entailed no assessment attributable to the texpayors treatment of individuals holding positions substantially similar to that held by the individual whose treatment is at issue. It should also be noted that the courts have taken an extremely , liberal view when it comes to applying the safe havens of Section 530. Clearly, in this case, dissimilarities exist between the Corporations present business of telephone solicitation and that of prior business activities of the shareholder. The extent of the dissimilarities is uncertain based upon the sketchy information evailable. At this point, the CPA is attempting to make the case that any nature of sales activities which occurred in the past and previously judged by virtue of an audit to be non-employee activities, would be sufficient to satisfy Section 530 requirements. This is not the view of the IRS. However, if the texpayer could ** reasonable show that the workers had telephone solicitation responsibilities, then indeed the weight of the case would shift in the favor of the taxpayer.

cc: Manager, Group 1315

10-26-95 (DTR)

Full Text:

IN THE UNITED STATES DISTRICT COURT FOR THE EASTERN DISTRICT OF TENNESSEE AT KNOXVILLE

No. 3:94-cv-121

SMOKY MOUNTAIN SECRETS, INC., Plaintiff

UNITED STATES OF AMERICA.
Defendant

MEMORANDUM OPINION

This is a tax refund action brought by the plaintiff-taxpayer, Smoky Mountain Secrets, Inc. (SMS), pursuant to 28 U.S.C. §1346[aX]), Plaintiff seeks a refund of Form 941. Federal Insurance Contribution Act (FICA) taxes and Form 940, Federal Unemployment Tax Act (FUTA) taxes, which plaintiff contends were assessed erroneously by the United States Department of the Treasury through the Internal Revenue Service (IRS). The total amount of taxes assessed is approximately \$1,888,918. This does not include interest on the assessments. The jurisdiction of this court is not disputed. This matter was tried before the undersigned without intervention of a jury on July 20, 1995. The parties were given additional time within which to file post-crial briefs. After consideration of the pleadings, the testimony of witnesses, the depositions and exhibits introduced at trial, the parties briefs and, the applicable law, the court makes the following findings of fact and conclusions of law. See Rule \$2(a), Federal Rules of Civil Procedure.

Findings of Fact

- SMS, a Tennessee corporation, markets gourmet (loads and condiments, including mustards, salad dressings, jellies and preserves. SMS sells its gourmet foods to consumers: it does not package and sell its products to other businesses for resale.
- Something during late 1991 or early 1992, defendant, through the IRS, initiated an audit of SMS which included a review of whether SMS's telemarketers and delivery persons were properly treated as independent contractors for federal lax outproses.
- federal tax purposes.

 3. During the tax years in question, the bulk of SMS's sales orders were solicited through telephone calls made by plaintiff's telemarketers, although some sales were made through mail orders received from repeat customers and through onthe-spot sales by delivery persons. The product orders solicited by the telemarketers were delivered to the customer's home by delivery persons who collected the amount due.
- 4. In addition to the telemarketers and delivery persons, all of whom were treated other than as employees for federal tax purposes during the 1989 and 1990 tax years. SMS employed workers who were and still are treated as employees for federal tax purposes. These employees include home office staff, warehouse workers, office managers, regional managers, and the officers of the corporation.
- 5. The telemarketers and delivery persons worked out of sales offices in various locations in approximately 14 different states during the tax years in question. No walk-in sales were made from these offices. Sales were only made through telephone solicitation and delivery of the package. For each package sold, which SMS defined as requiring

actual delivery to and receipt of payment from the customer, the telemarketer received a specific commission, the amount of which depended upon the size of the package sold and the year in which the transaction took place.

- 6. SMS's delivery persons were an integral part of SMS's sales force; their services did not consist of merely driving to the customer's home and handing over the package. The delivery person had to collect the amount due, which often meant that he or she had to close the sale. Neither the delivery person nor the telemarketer would be paid unless the package was accepted and paid for by the consumer. Thus, the reason SMS's own delivery persons were used instead of common carrier was to obtain the opportunity to close the sale face-to-face if a delivery was refused. Two of plaintiff's managers, Terry P. Goodall and Barbara Jean Thomas' each of whom had previously worked for SMS as delivery persons, testified that the person delivering the packages was often called upon to close sales, such as when a customer has changed his or her mind, did not know the terms of the sale, or when an unknowledgeable spouse refused to accept the package. Mr. Goodall and Ms. Thomas further testified that delivery persons also made sales on a "show-me" basis, in which additional packages are shown and sold to customers and to their neighbors. Consequently, I find that closing the sale was as much an art as was obtaining the order over the telephone in the first place.
- 7. Before going to work for SMS, each telemarketer and delivery person was required to sign a written contract. SMS's company president. Charles H. Allen, who along with his wife. Lois Allen, own 100% of the issued and outstanding stock of SMS, testified that it was corporate policy that all salespersons sign a contract before beginning work. The evidence establishes that the contracts clearly set forth that each telemarketer or delivery person would be paid on a commission basis, would not be treated as an employee for federal tax purposes, and that no federal, state or local income or payroll taxes would be withheld. The earlier forms of the contracts also stated that because the telemarketer or delivery person was not an employee, a Form 1099 would be issued and filed if the individual earned over \$600 during that year. The parties stipulated that SMS issued a Form 1099, as required by federal tax law, to every telemarketer and delivery person who earned \$600 or more during the 1989 and 1990 tax years.
- 8. These written contracts further provided that each telemarketer's delivery person's remuneration was directly related to the number of sales delivered and for which they were paid. Each year SMS corperate policy required every telemarketer and delivery person to sign a new contract. It was the responsibility of the manager of each sales office to obtain those documents. And, in fact, the contracts were signed by every telemarketer and delivery person before they started work.
- 9. Copies of form contracts between SMS and its telemarketers and delivery persons which were used during the
 years following the 1989 and 1990 tax years were admitted
 in evidence. As the undisputed testimony confirms, the
 contracts used in prior years were, in all relevant provisions, substantially the same as those in evidence. The
 contracts used in the 1989 and 1990 tax years provided that
 the service provider i.e., the telemarketer or delivery
 person would be paid on a per-package-sold basis and
 that the service provider would not be treated as an employer for federal tax purposes. The parties stipulated, however,
 that SMS has been unable to produce and does not have in its
 possession originals or copies of the written contracts for
 the tax years in question, even though SMS diligently

searched for them and even sought to obtain copies or originals from numerous third parties. The reason SMS was unable to obtain the contracts is that its certified public account (CPA); Edgar H. Gee, Jr., advised Mr. Allen, SMS's president, that it would be unnecessary to retain copies after the corporate books had been closed and the required tax returns, including Forms 1099, had been filed for the year. Mr. Gee did not consider it important to keep copies of the contracts between SMS and its sales force because 26 U.S.C. \$3508 does not address retention of contracts in any respect. Nonetheless, because it was SMS's corporate policy that every telemarketer and delivery person sign a new contract each year, and since the undisputed proof at trail indicated that contracts were, in fact, executed by all telemarketers and delivery persons during the tax years at issue. I find that SMS convincingly proved the existence of the contracts and their contents pursuant to Rule 1004(1), Federal Rules of Evidence.

10. Mr. Allen first sought Mr. Gee's advice in 1983, after having read a statement in a business publication which reported the addition of §3508 to the Internal Revenue Code (the Code). Because he realized that it possibly applied to nesses such as his, which utilized the services of sellers" treated them as independent contractors, Mr. Allen sought the advice of Mr. Gee as to whether the new Code provision would apply to SMS's relationship with its telemarketers and delivery persons. Mr. Gee is a CPA-who has been licensed and in practice for more than 20 years. He received his undergraduate degree in accounting from Western Kentucky University and a masters in Business Administration from the University of Tennessee at Knoxville. Mr. Gee started his professional career with what was then one of the Big Eight accounting firms. He has had his own ractice since 1977. Mr. Gee maintains a general accounting ractice, concentrating on small businesses, the most sig-nificant of which is SMS. He testified at trial that probably one-half of his practice is related to tax accounting and tax

11. Mr. Gee testified that when Mr. Allen first inquired about §3508 he was initially unfamiliar with the statute's requirements. The reason is that the statute had only recently been enacted. He therefore obtained a copy of the new statute prior to Mr. Allen's initial appointment, found that there were no regulations regarding \$3508, and analyzed the Code section with Mr. Allen, asking him pertinent questions regarding each of the elements set forth in the statute Based on the information gleaned from Mr. Allen, Mr. Gee opined that SMS's telemarketers and delivery persons were direct sellers as contemplated by §3508. Mr. Gee testified that his opinion was based upon Mr. Allen's description of the relevant facts about SMS's business, the manner in which the telemarketers and delivery persons would be compensated, and the fact that plaintiff had a written contract with its sales force providing that the telemanketers and delivery persons would not be treated as employees for federal tax purposes. Shortly after his meeting with Mr. Allen, Mr. Gee researched \$3508's legislative history. obtaining copies of the Senate and House Committee reports as well as the conference committee report; as well as the conference committee report. He gave copies of these reports to Mr. Allen, advising him that he remained of the opinion that SMS's sales force cualified as direct sellers under the statute. Mr. Gee was hired that same year as SMS's CPA with responsibility for closing the books at year-end, preparing financial statements as needed, and 'ing all tax returns, including employment tax and infor-.ation returns.

12. Unknown to Mr. Gee, Mr. Allen also consulted with the CPA who regularly prepared Mr. Allen's personal tax re-

turns, Jerry Lee Sharpe of Middlesboro, Kentucky, Mr. Allen asked Mr. Sharpe the same question regarding the proper tax classification of SMS's telemarketers and delivery persons. Mr. Sharpe, now semi-retired, has been a CPA since 1961. When he began his career, he worked for the IRS as a revenue agent for almost two years. While with the IRS, as a revenue agent for almost two years. While with the IRS, as a revenue agent for almost two years. While with the IRS, sa revenue agent for almost two years. While with the IRS, sa revenue agent for almost two years. While with the IRS, sa revenue agent for almost two years. While with the IRS, sa revenue agent for almost two years. While with the IRS, sa revenue agent for almost two years. While with the IRS, sa revenue agent for almost two years.

13. Like Mr. Gee, Mr. Sharpe advised Mr. Allen that he believed that SMS's telemarketers and delivery persons were properly classifed as independent contractors and not employees. He based this advice, however, upon his prior experience and knowledge of common law factors. Mr. Sharpe was not familiar with and did not discuss with Mr. Allen the application of \$3508. Some year's later, Mr. Sharpe called Mr. Allen regarding this issue after he had attended a three-day continuing professional education course, which was sponsored by the University of Kentucky and taught by IRS instructors. Mr. Sharpe advised Mr. Allen that the course's primary subject involved the IRS's new 20-factor analysis for determining whether workers are employees or independent contractors for federal tax purposes. After again analyzing SMS's sales force in the context of these 20 factors. Mr. Sharpe advised Mr. Allen that the telemarketers and delivery persons were properly characterized as independent contractors.

14. Mr. Gee has continued to perform certain accounting services for SMS since 1983. In addition to the specific advice he gave regarding \$3508. Mr. Gee has represented SMS in state unemployment tax investigations-involving the issue of the proper classification of SMS's telemarketers and delivery persons. A number of such investigations took place over the years and, consistent with his initial advice to Mr. Allen, Mr. Gee have taken the position with the states that the telemarketers and delivery persons were statutorily classified as independent contractors. Mr. Gee testified that most, if not all, of these investigations resulted in findings by the states that SMS's telemarketers and delivery persons were indeed properly treated as independent contractors rather than employees.

15. Based upon the undisputed evidence at trial, I find that

15. Based upon the undisputed evidence at trial, I find that SMS has, since its inception, treated all of its telemarketers and delivery persons as independent contractors. No telemarketer or delivery person has been treated as an employee for federal tax purposes.

Conclusions of Law

A. Section 3508 — Statutory Independent Contractors

1. This court has subject matter jurisdiction over this case pursuant to 28 U.S.C. \$1340 and 1346(a)1, and 28 U.S.C. \$7422. Because this is a tax refund suit in which the IRS counterclaims for the unpaid balance of assessments of divisible taxes, the IRS need only show that a timely assessment was made in order to establish a prima facile case. See Sinder v. United States, 655 F.2d 729, 731 (6th Cir. 1981). Thus, the assessment is initially presumed to be correct, and the taxpayer has the burden of proving that the assessment was wrong. Id. See also United States v. Bessae, 623 F.2d 463, 465 (6th Cir.), cert. denied, 449 U.S. 1062 (1980).

2. Prior to 1882, the question of whether a worker was an independent contractor or an employee for federal tax purposes was a question that was answered almost exclusively under common law. See Cleveland Institute of

Electronics, Inc. v. United States, 737 F Supp. 741 (N.D. Ohio 1992); H.R. Rep. No. 1748, 95th Cong., 2d Sess. 5, 1978-3 C.B. (Vol. 1) 629 (House Report discussing the enactment of the employment tax relief provisions of §530 of the Revenue Act of 1978. After enacting §530 of the Revenue Act of 1978 as an interim solution for employment tax controversies. Congress in 1982 made §530 relief permanent and, to further alleviate the problem for direct sellers and real estate sales persons, enacted 26 U.S.C. §3008. According to the legislative history, congress added §3508 to the Code as a response to the "problems arising from increased employment tax status controversies." and to provide "a statutory scheme for assuring the status of certain direct sellers and real estate sales people as independent contractors [for Iederal tax purposes]. Staff of Joint Comm. on Taxation. 97th Cong., 24 Sess., General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982, at 382 (Comm. Print 1982): Importantly, the "statute din not supplant the common law; rather, it merely guaranteed independent contractor status for those taxpayers who met its conditions." Cleveland Institute of Electronics, 737-F Supp. at 743-44.

- 3. Section 3508 thus establishes two categories of statutory non-employees: (1) qualified real estate agents and (2) direct sellers. The statute sets forth the general rule that an individual performing services as a "direct seller" shall not be treated as an employee and the person for whom the services are performed shall not be treated as an employer. \$3508(a(1)) and (2).
- 4. The term "direct seller" is defined in pertinent part in §3508(b)(2) as any person;

(A) [who]

•

(ii) is engaged in the trade or business of selling (or soliciting the sale of) consumer products in the home or otherwise than in a permanent retail establishment,

(B) substantially all the remuneration (whether or not paid in cash) for the performance of the services described in subparagraph (A) is directly related to sales or other output (including the performance of services) rather than to the number of hours worked, and

(C) the services performed by the person are performed pursuant to a written contract between such person and the person for whom the services are performed and such contract provides that the person will not be treated as an employee with respect to such services for Federal tax

The parties have stipulated that SMS's sales (the delivery of its gournet foods and condiments and receipt of payment) and the solicitation of its sales (by the telemarketers over the telephone) were made either in the home or from other than a "permanent retail establishment" as required by \$3500. The parties further stipulated that SMS's telemarketers were engaged in the business of 'soliciting the sale' of plaintiff's product as required by the statute. However, the parties dispute whether or not SMS's delivery persons were engaged in the business of soliciting the sale of plaintiff's products. I am of the opinion that they were. In fact, SMS's delivery persons were an indispensable part of selling SMS's products. Delivery persons had to be able to and did "closes" also on a regular basis. Indeed, the extent to which they received remuneration for their services was very often dependent on their success in closing sales. The telemarketers and delivery persons thus both clearly meet the first prong of the definition of "direct sellers;" they were engaged in the trade or business of selling or soliciting the

sale of consumer products in the home or otherwise than in a permanent retail establishment.

5. The next criterion which must be satisfied under §3508

- 5. The next criterion which must be satisfied under §3508 is that "substantially all the remuneration" paid to the worker be directly related to sales or other output rather than the number of hours worked. SMS compensated its telemarketer and delivery persons on a commission basis only if a package was delivered to a customer and the sales price actually collected were the telemarketer and delivery person to be paid. Thus, substantially all of the remuneration of, the telemarketers who received a Form 1099 for the 1989 and 1990 tax years was directly related to sales. Similarly, substantially all the remuneration of SMS's delivery persons during the 1989 and 1990 tax years was directly related to sales. SMS has thus met the second prong of \$3508's test.
- 6. The third requirement of \$3508 is that the services must 6. The Unitor requirement of 3500s is that the services must have been performed pursuant to a written contract providing that the service provider would not be treated as an employee for federal tax purposes. Although the IRS vigorously contends that SMS has failed to satisfy the written contract requirement of §3500(b)(2)(C), its argument is unatified. vailing. The IRS would require plaintiff to actually produce the written contracts for the years 1989 and 1990, However, this argument ignores Federal Rule of Evidence 1004(1). which clearly allows other evidence of the contents of an original writing to be introduced assuming all originals have been lost or destroyed. While Congress could have required something more within the terms of \$3508, it did not. The IRS has failed to cite any authority for the proposition that copies of the original contracts must be produced in order for the taxpayer to meet the third prong of \$3508. SMS introduced into evidence copies of form contracts similar in every material respect to those used in the tax years at issue. The contracts specifically provide that SMS's telemarketers and delivery person to sign these contracts and the evidence clearly reflects that the contracts were, in fact, signed by each telemarketer and delivery person in each of the tax years at issue. Therefore, the third requirement of the statute has been met; the services were performed under a written contract providing that the service provide would not be treated as an employee for federal tax purposes.
- 7. The IRS also contends that the court may reasonably infer from the existence of written contracts for years subsequent to 1989 and 1990, and the failure of SMS to produce the written contracts for the years at issue, that either no written contracts ever existed for such years or that, if they did exist, the written contracts did not contain the express provisions required by \$3508. Indeed, the IRS goes so far as to argue that the court may properly draw an analogy between the established principle that an adverse inference may be drawn from the failure of a non-hostile witness with direct knowledge of important facts to testify on a party's behalf. While the court could draw such an inference is SMS had adduced no proof on this issue, that is not the case here. The government itself stipulated that any and all persons whom SMS could call at trial on this issue would testify, as did Mr. Goodall and Ms. Thomas, that each telemarketer and delivery person signed written contracts as a matter of corporate policy. As noted in the leading case of Cleveland Institute of Electronics, Inc., 787 F.Supp. at 749, the legislative purpose underlying enactment of §3508 was to reduce the number of controversies regarding emplayment and income tax status of direct sellers and real estate agents. The court therefore must interpret the re-quirements of §3508 in a fashion which will further the statute's purpose. Therefore, because SMS has clearly dem-

instrated that its telemarketers and delivery persons meet the requirements set forth in \$3508, the court concludes that "MS's sales force were "direct sellers" as that term is used in \$3508 for the tax years 1989 and 1990.

8. Section 530 of the Revenue Act of 1978 — Professional Advice

8. Section 530 of the Revenue Act of 1978 (the 1978 Act) was enacted by Congress to provide interim relief to certain taxpayers involved in employment tax status controversies with the IRS. Donovan v. Tastee Frees (Puerto Rico). Inc., 520 F.Supp. 899, 903 (D.P.R. 1981). Section 530 of the 1978 Act is codified as a footnote to 26 U.S.C. §301. Congress intended that §530 would serve as a shelter for taxpayers who had acted in good faith from the potentially harsh retroactive tax liabilities resulting form IRS reclassification of independent contractors as employees. See United States v. MacKenzie, 777 F.2d 811, 815 (2d Cir. 1985). Cert. denied, 476 U.S. 1189 (1986) (citing Ridgewell's Inc. v. United States, 228 Ct. Cl. 393, 655 F.2d 1998, 1101 (1981)). As previously noted, §330 was later extended indefinitely by the Tax Equity and Fiscal Responsibility Act of 1982.

8. Although the court has previously concluded that the members of SMS's sale staff are properly classified as direct sellers under \$3508. I further conclude that SMS has demonstrated that it is entitled to relief under \$550Keyn if the telemarketers and delivery persons do not qualify as direct sellers.

10. The government has stipulated and the court finds that SMS has met the first two tests under \$530: that SMS has consistently treated its telemarketers and delivery persons.

as well as all individuals holding similar positions, as inde-

ndent contractors for federal tax purposes, and that SMS illed all required tax returns, including information returns, in a manner consistent with having treated the telemarketers and delivery persons as independent contractors. The term "reasonable basis" is to be construed liberally in favor of the taxpayer. See H.R. Rep. No. 1748. 95th Cong., 2d Ses. 1978-3 C.B. (Vol. 1) 629, 633. See also Lambert's Nursery and Landscaping, Inc. v. United States, 894 F.2d 154. 157 (5th Cir. 1990). General Inv. Corp. v. United States. 232 F.2d 337, 340 (9th Cir. 1987).

11. Section 530 provides three non-exclusive methods by which taxpayers can demonstrate a reasonable basis for having treated individuals as independent contractors rather than employees. The first of these statutory safe harbors reliance on judicial precedent or published rulings. The second of the statutory safe harbors is reliance on a past IRS audit of the taxpayer is which there was no assessment attributable to the treatment, for employment tax purposes, of individual holding positions substantially similar to those held by the workers at issue. The third statutory safe harbor is reliance on the long-standing recognized practice of the worker's industry. See \$530(a)(2). However, the language of \$530(a)(2) refers to the three statutory safe harbors as merely "one method of satisfying the requirements for the reasonable basis test]." Based upon that language, both the IRS in its procedural guidelines and the courts have held that "[a] taxpayer who fails to meet any of the three statutory] safe havens' may nevertheless be entitled to relied if the taxpayer can demonstrate, in some other manner, a reasonable basis for not treating the individual as an analysise." Fast Perpe R. 18, 18 See, 16, 8, 18 See, also for

ner, a reasonable basis for not treating the individual as an imployee." Rev. Proc. 85-18, 1985-1 C.B. 518. See also in Rasbury, 130 B.R. 990 (Bankr. N.D. Ala. 1991), aff d. United States v. Rasbury (In re Rasbury), 141 B.R. 752 V.D. Ala. 1992).

12. SMS claims that its reliance on the advice of two professional tax advisors is sufficient to demonstrate a reasonable basis under §530 for not treating its telemarketers and delivery person as employees. I agree. Under the circumstances of this case, reliance upon the professional advice rendered by two CPAs — Mr. Gee and Mr. Sharpe — constitutes a reasonable basis for SMS having treated its telemarketers: and delivery persons as independent contrac-tors:: It is undisputed that Mr. Gee explored with SMS's President, Mr. Allen, the facts about SMS's business relevant to the requirements found in §3508. Mr. Gee testified that he discussed with Mr. Allen that SMS's compensation structure would meet the "substantially all remuneration" ment, that a written contract was required, and that one existed which met the requirements found in the statute. After determining that the telemarketers and delivery persons would only be compensated on a commission basis and that a written contract meeting the requirements of the statute existed, Mr. Gee advised Mr. Allen that he believed \$3508 applied and that the telemarketers and delivery persons could and should be treated as independent contrac Thus, not only has Mr. Gee consistently filed all appropriate federal documents related to this status under §3508, he has also represented SMS in various state unemployment tax investigations and has consistently taken the successful position with those agencies that the telemarketers and delivery persons qualified as "direct sellers" under \$3508.

13. The IRS attacks SMS's reliance upon-Mr. Gee's advice based on the fact that Mr. Gee was unaware of the existence of \$3508 at the time Mr. Allen inquired of him. Because at that time the statute had just been enacted, and based on Mr. Gee's conduct in researching the matter, I am of the opinion that it was reasonable for Mr. Allen to rely upon the advice of his advice of his CPA. Only after he had examined the statute line-by-line in the context of the information provided by Mr. Allen did Mr. Gee opine that SMS had met the essential elements of \$3508.

14. I further conclude that SMS's reliance upon the advice

14. I further conclude that SMS's reliance upon the advice of Mr. Sharpe, who examined the information provided by Mr. Allen in the context of the common law factors governing independent contractor status, was reasonable, thereby further entitling SMS to the protection of §530. As did Mr. Gee, Mr. Sharpe testified as to his education and experience in similar tax matters and indicated that his advice was based upon the information provided by Mr. Allen. The IRS's reliance on In re McAtee, 115 B.R. 180 (N.D. lowa 1990), is thus misplaced. In that case, the taxpayer's accountant did not testify, nor was his identity disclosed on the record. Moreover, there was no evidence in the record as to exactly what advice the accountant gave the taxpayer or what information the taxpayer gave to the accountant. Id. at 184-85. By contrast, the undisputed testimony in this case indicates that, so far as Mr. Allen knew, Mr. Gee and Mr. Sharpe were fully capable and qualified to render advice on the question asked of them. It is also undisputed that Mr. Allen fully disclosed all pertinent information necessary for

his accountants to render that advice.

15. Although the term "reasonable basis" is not defined in the Code or regulations, an analogy may be drawn from those cases interpreting the term "reasonable cause" as it governs the determination of whether income tax penalties should be imposed upon a taxpayer. In determining if reasonable cause exists, the courts and IRS regulations generally look to see whether the taxpayer "exercised ordinary business care or prudence." See, e.g., 26 C.F.R. \$301.6551-(cXI). Generally, the courts have found that reasonable cause exists where the taxpayer relied on the advice

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of a trusted attorney or accountant. See, e.g., Vorsheck v. Commissioner, 933 F.2d 757 (9th Cir.), cert. denied, 502 U.S. 984 (1991). Indeed, in this regard, the Supreme Court has stated that:

When an accountant or attorney advises a taxpayer on a matter of tax law, such as whether a liability exists, it is reasonable for the taxpayer to rely on that advice. Most reasonable for the taxpayer to rely on that advice. Most taxpayers are not competent to discern error in the substantive advice of an accountant or attorney. To require the taxpayer to challenge the attorney, to seek "second opinion," or to try to monitor counsel on the provisions of the Code himself would nullify the very purpose of seeking the advice of a presumed expert in the first place. "Ordinary business care and prudence" do not demand such actions.

United States v. Boyle, 469 U.S. 241, 251 (1985) (emphasis added and citation omitted). Under the circumstances of this case, then, I conclude that SMS's reliance on the advice of two CPAs is a reasonable basis for treating its telemar-keeers and delivery persons as independent contractors, entitling it to the protection of §530.

C. Section 530 of the Revenue Act of 1978 - Prior Audit Safe Harbor.

16. The leading case involving the prior and audit safe harbor provision under §530(a)(2)(B) is Lambert's Nursery and Landscaping, Inc. v. United States, 894 F.2d 154 (5th Cir. 1990). The Fifth Circuit set forth the requirements the taxpayer must satisfy to meet the prior audit safe haven defense. The taxpayer must establish (1) that the IRS conducted a prior audit of the taxpayer for a particular tax year; (2) that the IRS determined in the prior audit that the axpayer's workers were independent contractors: (3) that the workers who were the subject of the prior audit are 'substantially similar" to the workers at issue; and (4) that substantially similar. Ut the two groups of workers in a "sub-stantially similar" fashion. Unlike the taxpayer in Lom-bert's Nursery, SMS failed to establish the existence of a past IRS audit of SMS. It did establish however, that Mr. Allen individually, as well as three corporations he owned in the early 1970's, were audited by the IRS. Mr. Allen never-theless admitted that he did not know for certain what year the purported audits took place, or for what tax years the audits were conducted. He also admitted that he has no records reflecting that audits were conducted, or to what tax years the audits pertained. Although he testified generally that no adverse independent contractor determination was made by the IRS, he was not able to testify about the precise results of the audits.

.17. Accordingly, while there was evidence that Mr. Allen treated SMS's sales force in the same manner as he had treated his sales force in his prior businesses, the evidence is insufficient for the court to conclude that SMS was entitled to rely on the results of the prior audit.

Conclusion

Therefore, because SMS's telemarketers and delivery persons are direct sellers under 26 U.S.C. §3508 or alternatively, because SMS is entitled to the protection of §530 on account of its reasonable reliance on professional advice, SMS shall be awarded judgment in its favor and against the United States in the amount of \$400, which represents the total amount of nployment taxes paid for the tax years at issue. Order accordingly.

> /s/ James H. Jarvis UNITED STATES DISTRICT JUDGE

Smoky Mountain Secrete has not actually paid the amounts assessed. Rather, it has for each assessment paid an amount equal sessed. Rather, it has for each assessment paid an amount equal to the property of 1992. This procedure is in full compliance with the IRS durstile last quarter of 1993. This procedure is in full compliance with the IRS durstile true. Each claim for refund has been disallowed by the IRS. These and other facts are included in written stipulations [Doc. No. 25] (field by the parties). The parties stipulated that the testimony given by Mr. Goodall and Ms. Thomas is consistent with that of all office managers, telemarketers and/or delivery persons working with SMS during the tax years in question, both with regard to SMS's corporate policies and the work of telemarketers and delivery persons.

Unlike \$500's reasonable basis standard, the reasonable cause test is not liberally construed in favor of the taxpayer.

End of Text

LIST OF RECENT TAX DECISIONS

Tax decisions received recently by BNA from various courts are listed below with a brief description of their subject matter. Copies can be purchased from BNA PLUS toll-free (800) 452-7773 nationwide; (202) 452-4323 in Wash-

Whitten v. Commissioner, US TC, No. 19965-94, T.C. Memo. 1995-508, 10/25/95 (on issue of proper characterization of expenses incurred by taxpayer Stanley Whitten in attending and participating in television game show "Wheel of Fortune" the court holds that expenses incurred are at best expenses, deductible as a miscellaneous itemized deduction under Section 67, rather than wagering losses under Section 165(d)).

> Wolfe v. Commissioner, US TC, No. 16773-93, T.C.

Memo. 1995-509, 10/25/95 (court finds that taxpayers' argument of a loan is not only unsupported by the record, but is clearly contrary to the record, and that IRS' determination with respect to unreported income is sustained).

Lauckner v. U.S., CA 3, No. 94-5747, 10/23/95 (because

IRS' penalty assessment against counterclaim defendant Umberto J. Guido Jr. under Section 6672 was made more than three years after the relevant returns were deemed to have been filed, district court properly held that IRS' assessment was time-barred; court rejects IRS contention that no statute of limitations, including the one contained in Section 6501(a), applies to IRS assessments under Section 6672).

. Algie v. RCA Global Communications Inc., DC SNY. No. 89 Civ. 5471 (MJLXMHD), 10/12/95 (severance benefits payments that defendant is required to make this year to plaintiffs pursuant to judgment, as a consequence of plaintiff's termination in 1988, are subject to withholding of FICA taxes and Medicare hospitalization insurance tax at the rates and and on the basis of formulas provided in the law as currently in effect this year, rather than the rates and

formulas in effect in 1988).

> Cardoza v. U.S., DC ECalif. No. CV-F 94-5539 REC.
9/27/95 (action against IRS for negligence, wrongful collection of taxes and punitive damages and against Wells Fargo and Standard Mortgage Co. for breach of contract, breach of fiduciary duty and punitive damages in suit involving four tax llens is concluded as Wells Fargo agrees to provide plaintiff with a check in exchange for a general release; plaintiff claimed that Wells Fargo lost a check which in turn caused him a number of financial problems).

> Toys "R" Us Inc. v. P.P.S.I. Inc., Mass SuperCt. No.

93B-01825, 9/6/95 (IRS may attach funds that Toys "R" Us Inc. admits it owes to taxpayer P.P.S.I. Inc., which acted as Toys "R" Us' agent in obtaining transportation services for Toys "R" Us from independent carriers, notwithstanding Chairman JOHNSON. Thank you very much, Mr. Gee.

I would like to go back to Ms. Abalos. I was interested in your comments that you said you have read the new training manual. Ms. Abalos. Yes.

Chairman JOHNSON. And you believe it to be subjective. Could you enlarge on that?

Ms. ABALOS. The training manual, when you read through it,

first, it is 100 pages long, you have a 100-page manual.

Chairman JOHNSON. I thought that was a very good point you

Ms. ABALOS. To give some definition to this issue, it expands; it talks to the IRS auditors about looking for elements of behavioral and financial control. But again, it works within the common law factors we have today. It still does not give any kind of a test or a checkoff or specific elements to look for that would say yes, you are an independent contractor, or no, you are not. It is just an accumulation of data, and, again, it is a look at the overall facts and situation, and you look and you make a determination.

But as we all know, that is the difficulty about the 20 common law factors. We may interpret it one way, the Service Center may interpret it another way. Ultimately, it goes to the courts, and we have heard testimony from the other witnesses that the courts have in many instances sided with the small business and that the

IRS has been abusive in this determination.

Chairman JOHNSON. As a CPA and one with a master's in

accounting, do you think there is a simple test?

Ms. ABALOS. I think the criteria established in H.R. 1972 is a good start and it is a good beginning in the direction that we need to go.

What we are looking for is just something that a small business owner or practitioner can look at and have a reasonable assurance. With the 20 common-law factors we have no clue.

Chairman JOHNSON. Do you think the criteria in H.R. 1972 need to be strengthened?

Ms. ABALOS. Perhaps.

And in response to the question with the airline pilot, he would not be an independent contractor because under his situation he would not have a principal place of business. His principal place of business would be in the airplane itself. That is where he is conducting his service.

Chairman JOHNSON. Under the law, he would not have a prin-

cipal place of business other than the cockpit?

Ms. ABALOS. That is correct.

Chairman JOHNSON. Thank you.

I will let my colleague pursue that. I am sure that he will want

You implied perhaps one way to strengthen the Christensen bill is to use "and" instead of "or." Would it become too cumbersome if we were to do that?

Ms. ABALOS. I think we need to look at the criteria. We are not interested in just throwing something out that lends to a whole other set of difficulties. It does need to be examined. Every little "and" and "or" needs to be thought through and looked at with specific industries and situations in mind. So, I cannot just say I think "and" should be here instead of "or," but—

Chairman JOHNSON. Anyone on the panel who wants to comment, we do not have clear data on what money we are losing in this area. We do not know whether we are losing money because people are able to duck the system and not pay their taxes or whether we are losing money because as an independent contractor you can deduct costs that the prime employer could not deduct in such great volume, that every independent contractor can deduct overhead and the total amount of deduction is greater than the single employer, whether that is the cause of loss of income.

What would be your evaluation of the tax liability of the independent contractor as opposed to that person's tax contribution? Were they an employee? Are you paying more or less taxes if you are an employer? Are you paying more or less taxes if the same person is an independent contractor? Is there any rule of thumb?

Ms. ABALOS. I have two comments. One I think specific criteria will enhance compliance, and the reason I say that is when you have a ruling or a set of facts that is subjective, then when we do an analysis of those, we tend to lean more toward our—what favors our position. And I think you probably have more people classed as independent contractors that may come under the criteria of an employee if we had clear determination.

And then to a certain degree people are out there playing an audit lottery and then they do not file a 1099 because they perceive that the filing of 1099s is a target or trigger of an investigation or an audit. If you have clear criteria and someone can say, yes, I am, and, no, I am not, and if I am, I had better file 1099s or I do not get to come under this testing criteria. I think you will see better reporting by the small business community with this issue overall.

And to answer your question as to whether somebody pays more or less tax depending on their classification, it depends on what kind of business expenses they are incurring independently. If they are an employee and have unreimbursed business expense, those are often not deductible because they go into miscellaneous itemized deductions and they are phased out and they do not have the same impact as business expenses from a self-employed viewpoint. So, it is—I do not know that I can make a very clear analysis of that. It is just a different treatment of those unreimbursed expenses whether an employee or an independent contractor.

Chairman JOHNSON. Does anyone else on the panel have a comment particularly on the issue of do you pay more or less as an independent contractor? It is very important because if this sort of tax gap, as they call it, is the result of legitimate deductions of independent contractors then government has no right to the money. If the tax gap is the result of evasion then it is a fair share, fair burden issue.

We do not at this point, at least I am not aware at this point, and I will ask the IRS this when they come before us in a couple of weeks that we understand what the tax gap does represent, but it is true that the problem of compliance in the independent contractor sector is a real one. I hear you saying, Ms. Abalos, that you think clear definitions will make it easier for the public to comply, and easier for us to enforce the law.

Ms. ABALOS. That is my opinion, yes.

Chairman JOHNSON. Mr. Barbee.

Mr. BARBEE. One thing that offsets when you are self-employed you pay both sides of your FICA taxes. The only advantage that an independent contractor picks up in some cases is the legitimate expense of them doing business. Go back at least to what it cost them to do their trade or do their work. They do get hit with the double side of the employer-employee FICA taxes so the wash out is about the same.

Chairman JOHNSON. Thank you. Before I yield to Mr. Matsui a number of you are from the cable industry. I was interested in, Mr. Bolt, your testimony that the cable industry has since its inception operated through independent contractors. Is that true?

Mr. Bolt. Yes, that is correct. At least in the interpretation.

Chairman JOHNSON. So, the IRS is imposing this standard. Would it represent a clear break with the past for the entire industry of cable installation?

Mr. Bolt. Yes, I believe so.

Chairman JOHNSON. And why is it important to have your installers be independent? Is there a business reason why it is better

if they are independent rather than your employees?

Mr. BOLT. Most of them prefer to be independent. They can change companies that they work for at will. They can go where they want. Since I have been in the business, that is the way I learned it, and everyone that works for me wants to be an independent contractor.

Chairman JOHNSON. Do some of the people who work for you work for other cable companies, too?

Mr. Bolt. Yes, some of them do.

Chairman JOHNSON. Depending on the volume and demand.

Mr. BOLT. That is correct.

Chairman JOHNSON. So, it gives them and you flexibility?

Mr. Bolt. Yes, that is also correct.

Chairman JOHNSON. Thank you.

Mr. Matsui.

Mr. MATSUI. Thank you, Madam Chairman.

Mr. Bolt, I would just like to follow up. I understand that installers for cable companies, there are some ambiguities. And what are they in terms of the company that you work with, what are installers?

Mr. Bolt. They are independent contractors.

Chairman JOHNSON. They are independent contractors at this particular time. And do you know of any case where that might be different in other cable jurisdictions?

Mr. BOLT. The installers that work directly for the cable systems themselves they do have some employee relationships, but all the contracting companies that I work with all use independent contractors.

Mr. MATSUI. Because it would seem to me that there is a lot of ambiguity in this part of the law. What is an employee and the issue of control and independence and all of that. Obviously, it is a major concern of yours as well; is that correct, because you do not want to be hit with a significant liability if all of a sudden

these independent contractors come into question and become, or the service interprets them as employees; is that your concern?

Mr. BOLT. Yes, of course.

Mr. MATSUI. Obviously. That is an area we obviously have to get into and that is an area that is a very difficult one. Everybody is trying to grapple with. Senator Gramm raised the issue of the newspaper delivery boys and right now the issue of distributorships that come into play, as you well know. It is so complex and there is no question that there is a lot of discretion involved in this particular area by the service and obviously Treasury and others as well, so it does have to be further clarified. The issue is how we clarify it.

I was very interested in your comments, Mr. Barbee, because you indicated both here today and in your testimony that you felt it was an issue of enforcement, not to a large extent, not so much an issue of whether legislation is needed. Perhaps you can elaborate on that somewhat because that very likely could be the situation though obviously Treasury and IRS particularly will have to come up with stronger and more accurate regulation.

Mr. Barbee. I feel that the law works. The law—the section 530 of the law is good, it works. My case proves it. There are a lot of cases out there that prove this issue. The problem is that the Internal Revenue Service snubs their nose at the very people that pass the laws, to the very people that protect us, not take care of us,

but protect us. You were elected by the people to protect us.

And then you pass this law. And it is very clear. It says, "liberally construed in favor of the taxpayer," emphasis added. How much clearer does it need to be? And then we throw in words like,

"significant." What does significant mean?

Now, \$29,000 in legal fees, to me, is a significant number, but in Washington, DC it is not a significant number. Five percent of the Coca-Cola empire is a significant market share dollarwise. But it is a small market share for Coca-Cola. So what does the word, "significant," mean?

It is almost like normal. What is normal on Broadway is not necessarily normal in Augusta, Georgia. So, we have to watch that. That is what scared me more than anything else. If we start tinkering with the law and adding little fuzzies to it, it is not as clear,

but more unfocused.

Mr. MATSUI. I appreciate that comment. You know, I sympathized with Mr. Bolt in what might happen, if you will. All of a sudden the Service goes in and reinterprets that employment relationship or that relationship between the company and also the installer. And it is an issue we have been trying to grapple with for

20 years. I have been here 18 years now.

I remember when Congressman Pickle, who was chair of the Subcommittee in early 1980, had some Committees on this. I was not on the Subcommittee at that time, but the same issues were being raised. The real problem that is being faced today isn't your problem. The real problem is if we pass legislation that is so narrow, all of a sudden it could be abusive and employees could be redefined as independent contractors to lose valuable benefits such as pension benefits, health care benefits, that is what we need to be sure we do not do.

I think, Ms. Abalos, you, in your testimony talked about a horror story where an architect friend of yours working for the same company for 20 years was declared an independent contractor by his employer losing valuable benefits and we do not want to see that situation occur as well. So, we have to be very narrow in how we deal with this issue or very balanced, I should say, as to how we deal with this issue.

I have read Mr. Christensen's bill three times now. I read it last night, this morning, and I read it again because I wanted to be sure of the interpretation. The problem is you talked about the airline pilot. Ms. Abalos, you mentioned it would not happen because the principal place of business problem.

Airline pilots obviously do not provide the service at United Airlines headquarters. They provide it in the air in an air craft. That individual could be interpreted as an independent contractor

under this legislation.

What you need to do is you need to read this in the disjunctive not the conjunctive. If you read it in the disjunctive, you will find that all you need to do is satisfy, one of the six or one of the seven. If you read it that way you will find a whole different interpretation.

I assure you that the legislative counsel's office and the courts will interpret it, and I believe that is what the intent of the bill was. The intent of the bill was to make it easier to declare an employee an independent contractor and that is why millions of people could be declared independent contractors.

Frankly, that will save the employer a great deal. The pension benefits, health care benefits, and many things that create insecurity in America today. There is no question that is what this bill does. That is why the NFIB supports this bill. But the fact of the matter is do not mix your problem, which is a legitimate problem, with the problem of this bill because this bill addresses a totally different issue than the issues that you have concerns about.

I think Mr. Bolt, Mr. Barbee, all of you have raised very legitimate concerns, but do not be seduced by this legislation because this legislation will put you in a position where even a reporter can be declared an independent contractor through the interpretation under this bill.

And that is all I would request is that as you pursue this issue, and you legitimately pursue this issue, because it has to be addressed, we do not want to create ambiguities and problems for all of you in the future. Just do not be misled by legislation that might have a different interpretation ultimately than you think it does. Thank you.

Mr. GEE. Madam Chairman, if I could just have one further comment.

Chairman JOHNSON. Yes, Mr. Gee.

Mr. GEE. I think it is important to remember that you have people sitting in front of you who believe the problem is not so much clarification, the problem is we need a change of heart, a change of mind, a change of attitude at the Internal Revenue Service.

I would remind you that my particular case was litigated under sections 3508 and 530, the two laws that the Congress specifically enacted years ago to avoid the very problems we are sitting here telling you about. You can have a law as clear as spring water in east Tennessee. If you do not have a change in attitude at the national level, at the Internal Revenue Service, none of this is going to work.

Thank you very much.

Chairman JOHNSON. Mr. Gee, we appreciate that, but we wrote as clear a law in 530 as we possibly could, and you heard Congressman Kim's proposals for dealing with that law, for instance, is a significant portion of your work force, 90 percent of your employee work force, 90 percent or should it be 20 percent? Clearly, the IRS is incapable of dealing with defining "significant" fairly. They define it whatever way they want if they need it. That is unfortunately the evidence.

So, we have to do something. This Committee isn't into behavioral modification. We do not have the ability to modify the behavior of the bureaucracy. We do have the ability to change the law. We tried it, and when we passed section 530 we made it absolutely as clear as possible how the law should be construed, and it did not work. You are living proof of it and the continued problems in this

area are living proof of it.

Now, I think that while I hear what you are saying, Mr. Barbee, about, "I am evidence that it works." You didn't have to close shop before you could get to the point of going to the court and not everybody has those resources. So, I cannot just assume that because you won in court you are living evidence. Also, I would ask Mr. Gee, with your experience, or any of you, what procedural changes would you make in the existing rules to ensure that taxpayers get a fair shot?

Mr. GEE. Here is what I would do, if I might. I would do one of the things that's been suggested already; that at the agent level that as soon as the issue is raised that you break that out and you get some clarification, opinion, or ruling, or something like that where the taxpayer can put in writing the fact that they meet section 530 or 3508 or whatever the reasons they think they are independent contractors. Then, what I would do is you have that in writing.

Chairman Johnson. That is to require the IRS to put in writing

why you do not comply?

Mr. GEE. And the taxpayer would put in writing why they thought they did.

Chairman JOHNSON. At the very beginning of the process?

Mr. GEE. At the very beginning as soon as the issue is raised. Then what I would do is if the IRS pursues the case as they did in my case and loses, I would make the IRS pay attorneys' fees from the agent level forward, the CPA fees—

Chairman JOHNSON. Excuse me, I didn't understand the second.

The IRS pay the attorneys fees and what?

Mr. GEE. CPA fees from the agent level forward. That will stop egregious abuses of behavior.

Chairman JOHNSON. What do you mean by that, from the agent

level forward?

Mr. GEE. I will give you an example. This gentleman over here. I think he said he spent \$29,000 on lawyers' fees or something. My client spent almost \$300,000. He cannot even recover half of those

because you do not get to recover your attorneys' fees until the deficiency notice is issued and that is usually about halfway through the cases, so if the Service knew they were looking at refunding all of your attorneys' fees, not just a fraction, they might have a little different attitude about the hazards of litigation.

Thank you.

Chairman JOHNSON. Thank you, Mr. Barbee.

Mr. Barbee. I want to say section 530 worked. The process that took place I had to go to work to stop the IRS from seizing the assets from our company. I had to get a Federal judge to issue a temporary restraining order against the Internal Revenue Service to enjoin them collecting the money. Taking the money away from me where I couldn't even fight them. I would not have had a chance at all, and the issue was to get a temporary restraining order to stop collection, which is as strong as a garlic milkshake to do. It is very difficult to do.

The Supreme Court has made that emphasis—a very strong emphasis to do. I had to have a temporary restraining order before it could get the hearing about my case. But it was an over zealous Internal Revenue Service. It was an action on their part, and I felt it was driven from Washington. It was not some renegade out here on a reservation, so to speak, in the country. It was directed strictly or straight out of the halls of Washington. And that is the part. But again, I cannot emphasize enough how clear Congress wrote the law. It is how flagrantly the IRS ignored the law; that is the problem doesn't anyone know how to control the IRS.

Chairman JOHNSON. Part of that would be greater accountability

throughout the process.

Mr. BARBEE. That is correct.

Chairman JOHNSON. Producing specific information. It is an outrage that you should get to court and never even in court have gotten sufficient documentation of their case; no testimony and so on. So, that is something we can look at, and the issue of penalties you are raising is a very valid one. We have been joined by my colleague, Mr. Collins. It is a pleasure to have you with us.

Mr. COLLINS. Thank you, Madam Chairman. I just dropped by briefly. Mr. Barbee came by our office early this morning. We were

reviewing this particular case.

As we were discussing it, when you get down to simplification, it is much easier for the IRS to focus in on one person for the purpose of collection of revenues than it is to go through the broad range of the independent contractors out there and wait to yearend to collect from them. That is the reason why the IRS objects to the independent contractor law. I think it is a shame.

I think we would have a lot more small jobs, small businesses created if we had a different interpretation by the IRS. It is a hinderance, it is a discouragement, a disincentive to get into business. It's not very profitable to get into business, and have the IRS come in and do as they have done to Mr. Barbee. Hopefully, we will be able to straighten out the language that pertains to independent contractors and maybe when we actually reach down and our Chairman of the main Committee says pull the IRS by the roots, we will get their full attention. There will only be a few over there to audit the amount of money that comes in from the States from

the consumption tax or the flat tax and we will not need quite as many of those people out there intimidating the small business people and small taxpayer of this country.

Thank you, Madam Chairman.

Chairman JOHNSON. Thank you, Congressman Collins. Before I dismiss this panel and invite the next panel to come forward, I do want to clarify an aspect of your testimony, Mr. Kessler. I had asked Mr. Bolt earlier to restate for the record the fact that installers in the cable industry have been treated as independent contractors since the inception of their industry in 1952 or thereabouts. It is interesting that in your first audit in 1989, the IRS treated your employees as independent contractors.

Mr. KESSLER. Yes, they did.

Chairman JOHNSON. Is it your experience that throughout the industry the installers were treated as independent contractors in 1989?

Mr. KESSLER. To the best of my knowledge, yes, especially in the State of New Jersey where we do most of our work. The audit I did have was a general audit. It was not specifically to examine these subcontracting areas so we got a clean bill of health on the normal business procedures that we had in terms of paying our taxes and so forth, but they also ruled on the way we treated subcontractors.

Chairman JOHNSON. You say in your testimony they carefully

scrutinized your use of subcontractors.

Mr. KESSLER. Yes, I helped my accountant prepare for the audit,

and I pretty well know what they looked at.

Chairman JOHNSON. Six years later in 1995, last year, they came in with a very different idea of what an independent contractor was and who was an employee and who was an independent contractor; is that your testimony?

Mr. KESSLER. Yes, it is ma'am.

Chairman JOHNSON. You also testified there were threats and in-

timidation. What do you mean by that?

Mr. KESSLER. What I think I mean by that is that when I know I am being offered some sort of deal, they called at the end of May and usually the way it works is they may say if you pay this and comply, we will only charge you this or else we can go back 5, 7 years, whatever the case may be. That is rather intimidating for a company my size. I could end up maybe spending, lets say, \$100,000 in fines, if that is what the deal is. Or, in 7 years I am out of business, I am not anywhere at all.

Chairman JOHNSON. And did they ever in this most recent audit discuss with you the issue of industrywide practice or historic

precedent or did you ever raise it with them?

Mr. KESSLER. I think we raised it in our section 530 prior audit. We always thought that a prior audit was a slam dunk. I am pretty sure my accountant brought up industrywide practice in particular in the State of New Jersey.

Chairman JOHNSON. What was IRS' response to the fact that section 530 should clearly have covered you, particularly in light of

an earlier audit?

Mr. KESSLER. I do not think they respected what happened in 1989. He seemed to believe that——

Chairman JOHNSON. Did they give any answers when you asked questions?

Mr. KESSLER. I will be honest with you, Madam Chairman, I just helped prepare the audit. I was not there. If you want a statement

from someone, I will give it to you.

Chairman JOHNSON. We may pursue that, but I think it is very clear in this instance the IRS is moving against an industry where the precedents are so clear that they should automatically be a section 530 case and that concerns me very much. It concerns me that you have been forced to cover extensive costs. It concerns me, Mr. Bolt, that your company is on the verge of folding as a result of this, and this is an issue that we will pursue.

I thank the panel very much for your testimony today. It is very

helpful.

I would like to call forward the next panel: Sam Meek of Talbot County, Maryland; Scott Bryan of Anaheim, California; John Budzinski, Milwaukee, Wisconsin; Raymond Kane, New York, New York; Lauraday Kelley from Harrisburg, Pennsylvania.

Thank you for being with us today.

We will start with Mr. Meek, the superintendent of the Talbot County Schools, Talbot County, Maryland.

Thank you. Nice to have you, Mr. Meek.

STATEMENT OF J. SAM MEEK, ED.D., SUPERINTENDENT, TALBOT COUNTY PUBLIC SCHOOLS, TALBOT COUNTY, MARYLAND

Mr. MEEK. Madam Chairman, Members of the Subcommittee, I appreciate having the opportunity of addressing this Subcommittee. My name is Dr. Sam Meek. I am the superintendent of Talbot County Public Schools. Talbot County is located on the Eastern Shore of Maryland. As superintendent, I am responsible for all of the public elementary, middle and high schools located in Talbot County.

In early 1994, the IRS conducted an employment tax audit of my school system. In particular, the IRS examined the school board's treatment of the school bus contractors who are contracted with us

to provide bus transportation to our students.

These bus contractors own their own buses. The contractors may or may not drive their buses. Rather, they are free to hire qualified drivers to drive their buses in the performance of these services. These schoolbus contractors have been treated by the board as independent contractors for employment tax purposes for decades. The board issues 1099s to these contractors reporting the payments made to them, and we transmit the 1099 information to the IRS.

In addition to the contractors, the board employs drivers to drive buses owned by the school system. In general, these buses are for the transportation of students needing special attention, such as handicapped or special education students. These buses which are owned by the school system are specially equipped. The buses

which are owned by the contractors are not.

The IRS agent who conducted the audit concluded that the schoolbus contractors should be treated as employees of the school system. Recognizing that we issued 1099s to the contractors, he applied the relief provisions of IRC section 3509. Nevertheless, he de-

veloped a deficiency of about \$160,000 for a 2-year period of time. He also determined that relief under section 530 was not available to us because we employed drivers to drive buses owned by the school system. He did not believe that the differences between a contractor who owns his own bus and who is not required to drive the bus, compared to an employee driver who drives a school system bus, were sufficient to allow for the application of section 530.

We proceeded to take an appeal from the IRS agent's report to the Appeals Office of the IRS. Because of our concern over the potential tax liability that could be developed by the IRS and the potential costs of litigation, we engaged in settlement discussions with the Appeals Office. After the appeals officer determined that there was a significantly high degree of compliance by the contractors in their reporting of the income paid by the school system to them, for which we were given credit for settlement purposes, the tax deficiency was substantially reduced from approximately \$160,000 to \$12,000.

We have submitted a closing agreement to the IRS in which we would agree to pay the \$12,000 deficiency and also agree to start treating the bus contractors as employees starting in September 1997 if no substantial changes are made in the relationship between the board and the contractors in the interim. This was an agreement that was worked out with Appeals over the course of several months. The signed closing agreement is now being held by the Appeals Office, and we expect to receive a fully executed copy of the agreement from the IRS very shortly.

Four other county boards of education within Maryland also have been audited by the IRS and have taken appeals. It remains unclear what will happen with the remaining county boards within the State. While we were hoping that whatever result occurred from the IRS audit would be handled in a uniform manner among all of the boards within the State, the sequential auditing of the school boards followed by the taking of appeals from each audit and the uncertainty of further audits of other boards may result in different treatment by the IRS of otherwise similarly situated boards within Maryland.

This entire process has been extremely time consuming, costly and disconcerting. It has caused a tremendous amount of concern within my school board and the other four boards that have been audited, concern among the taxpayers of each of the affected school boards as well as for the schoolbus contractors not only with the particular boards that have been audited, but throughout the State. In addition, schoolbus contractors located throughout the country are focusing their attention on this situation in Maryland.

Administratively, section 530 was of no relief to us. Even though we dispute the lack of "substantive consistency" because we believe there is a substantial difference in position between contractors who own their own buses and are not required to drive their buses, from school employees who drive school-owned buses, we did not want to face the risks and costs associated with litigating this issue.

Although the settlement negotiated with the Appeals Office was, in certain respects, similar to a settlement that could be achieved under the classification settlement program, the settlement does

have material differences. As I understand it, the classification settlement program requires prospective compliance starting in the next quarter. As a public body, budgeting for school board expenses has to be done several months in advance of the school year. Contracts for schoolbus contractors are entered into prior to the beginning of each school year. A board does not have the flexibility of rearranging its relationship with its contractors during a school year. Rather, a substantial lag time is needed in order to rearrange relationships with contractors to the board. The classification settlement program does not allow for this.

If we are forced to treat the contractors as employees starting in September 1997, this will greatly alter the relationship between the school board and the contractors. Aside from shifting employment tax responsibility from the contractors to the board, there are additional issues that need to be considered, such as the inclusion of contractors within retirement plans, fringe benefits, employee

grievance procedures and so forth.

Neither the contractors nor the board want their contractual relationship changed. These are relationships that have been in effect for over 40 years. For this reason, I urge the enactment of legislation that would permit us to continue treating schoolbus contractors having a significant investment in their own buses as independent contractors. Should such legislation not be enacted, we will need to consider our options. Although one option would be to bring the contractors in as employees as required by the IRS, other options would include hiring a large private bus contractor, who may or may not use the buses and services of the existing contractors.

Schoolbus contractors are small businessmen. They want to continue operating as small businessmen. Legislation that would recognize bus contractors as independent contractors, where they have a substantial investment, a written agreement with the school board, and do not perform services on the premises of the board

would accomplish this.

The collateral benefits and rights that may be associated with employee reclassification represent substantial additional administrative and financial burdens for all local school boards across the Nation. This is not something that either my board or the contractors in my district want. The IRS should not be in a position to require such a costly rearrangement of business transactions between parties where it is of little or no tax consequence to the IRS.

I thank you for this opportunity to bring this situation to your attention, and I would be pleased to entertain your questions.

[The prepared statement follows:]

STATEMENT OF J. SAM MEEK, Ed.D., SUPERINTENDENT OF SCHOOLS TALBOT COUNTY PUBLIC SCHOOLS TALBOT COUNTY, MARYLAND

BEFORE THE HOUSE COMMITTEE ON WAYS AND MEANS SUBCOMMITTEE ON OVERSIGHT JUNE 4, 1996

Chairman Johnson and Ladies and Gentlemen of the Subcommittee:

I appreciate having the opportunity of addressing this Subcommittee. My name is Dr. Sam Meek. I am the Superintendent of Talbot County Public Schools. Talbot County is located on the Eastern Shore of Maryland. As Superintendent, I am responsible for all of the public elementary, middle and high schools located in Talbot County.

In early 1994, the IRS conducted an employment tax audit of my school system. In particular, the IRS examined the school Board's treatment of the school bus contractors who are contracted with to provide bus transportation to our students. These bus contractors own their own buses. The contractors may or may not drive their buses. Rather, they are free to hire qualified drivers to drive their buses in the performance of these services. These school bus contractors have been treated by the Board as independent contractors for employment tax purposes for decades. The Board issues 1099s to these contractors reporting the payments made to them and we transmit the 1099 information to the IRS.

In addition to the contractors, the Board employs drivers to drive buses <u>owned</u> by the school system. In general, these buses are for the transportation of students needing special attention, such as handicapped or special education students. These buses which are owned by the school system are specially equipped. The buses which are owned by the contractors are not.

The IRS agent who conducted the audit concluded that the school bus contractors should be treated as employees of the school system. Recognizing that we issued 1099s to the contractors, he applied the relief provisions of IRC §3509. Nevertheless, he developed a deficiency of about \$160,000 for a two-year period of time. He also determined that relief under Section 530 was not available to us because we employed drivers to drive buses owned by the school system. He did not believe that the differences between a contractor who owns his own bus and who is not required to drive the bus, compared to an employee driver who drives a school system bus, were sufficient to allow for the application of Section 530.

We proceeded to take an appeal from the IRS agent's report to the Appeals Office of the IRS. Because of our concern over the potential tax liability that could be developed by the IRS and the potential costs of litigation, we engaged in settlement discussions with the Appeals Office. After the Appeals Officer determined that there was a significantly high degree of compliance by the Contractors in their reporting of the income paid by the school system to them, for which we were given credit for settlement purposes, the tax deficiency was substantially reduced from approximately \$160,000 to \$12,000. We have submitted a Closing Agreement to the IRS in which we would agree to pay the \$12,000 deficiency and also agree to start treating the bus contractors as employees starting in September 1997 if no substantial changes are made in the relationship between the Board and the Contractors in the interim. This was an agreement that was worked out with Appeals over the course of several months. The signed Closing Agreement is now being held by the Appeals Office and we expect to receive a fully executed copy of the Agreement from the IRS very shortly.

Four other county Boards of Education within Maryland also have been audited by the IRS and have taken appeals. It remains unclear what will happen with the remaining county Boards within the state. While we were hoping that whatever result occurred from the IRS audit would be handled in a uniform manner among all of the Boards within the State, the sequential auditing of the School Boards followed by the taking of appeals from each audit and

the uncertainty of further audits of other Boards, may result in different treatment by the IRS of otherwise similarly situated Boards within Maryland.

This entire process has been extremely time-consuming, costly and disconcerting. It has caused a tremendous amount of concern within my School Board and the other four Boards that have been audited, concern among the taxpayers of each of the affected School Boards as well as for the school bus contractors not only with the particular Boards that have been audited, but throughout the State. In addition, school bus contractors located throughout the country are focusing their attention on this situation in Maryland.

Administratively, Section 530 was of no relief to us. Even though we dispute the lack of "substantive consistency" (because we believe there is a substantial difference in position between contractors who own their own buses and are not required to drive their buses from school employees who drive school-owned buses), we did not want to face the risks and costs associated with litigating this issue.

Although the settlement negotiated with the Appeals Office was, in certain respects, similar to a settlement that could be achieved under the classification settlement program, the settlement does have material differences. As I understand it, the classification settlement program requires prospective compliance starting in the next quarter. As a public body, budgeting for School Board expenses has to be done several months in advance of the school year. Contracts for school bus contractors are entered into prior to the beginning of each school year. A Board does not have the flexibility of rearranging its relationship with its contractors during a school year. Rather, a substantial lag time is needed in order to rearrange relationships with contractors to the Board. The classification settlement program does not allow for this

If we are forced to start treating the contractors as employees in September 1997, this will greatly alter the relationship between the School Boards and the contractors. Aside from shifting employment tax responsibilities from the contractors to the Board, there are additional issues that need to be considered such as inclusion of the contractors within retirement plans, fringe benefits, employee grievance procedures, etc. Neither the contractors nor the School Boards want their contractual relationship to be changed. These are relationships have been in effect for over forty years.

We do not want to alter the long established relationship between the school system and the contractors. For this reason, I would urge the enactment of legislation that would permit us to continue treating school bus contractors, having a significant investment in their school buses, as independent contractors. Should such legislation not be enacted, we will need to consider our options. Although one option could be to bring the contractors in as employees as required by the IRS, other options would include hiring a large private school bus contractor who may or may not use the buses and services of the existing contractors. The potential loss that may be suffered by the existing contractors if this occurs represents a substantial risk now being faced by the existing contractors. This alone is a factor pointing to the magnitude of the investment maintained by the contractors in their buses that distinguishes them from mere employees.

The school bus contractors are small businessmen. They want to continue operating as small businessmen. Legislation that would recognize contractors as independent contractors where they maintain a substantial investment in assets, have a written agreement with the School Board and do not perform services on the premises of the service recipient would accomplish this.

Through the Appeals process and the negotiation of the Closing Agreement, it was determined that compliance by the Contractors in reporting payments made to them on their tax returns has been very high, ranging from about 85% to 100% among the five boards that have taken appeals. Other measures can also be considered so as to ensure a continued high level of reporting compliance by all of the contractors. For example, requiring the service recipient to obtain a Fact of Filing Authorization from contractors pursuant to which the service recipient

would be permitted to confirm that a tax return was filed with the IRS would achieve this purpose.

From the IRS' perspective, an insubstantial amount of additional revenue will be raised as a result of these audits. Prospectively, requiring employee treatment has a potential to significantly alter the relationship between the school system and the contractors. The additional costs associated with this are not revenue raisers for the IRS. Rather, the collateral benefits and rights that may be associated with employee reclassification represent potential substantial additional administrative and financial burdens for the School Board that may be the result of this rearrangement. This is not something that either the Board or the Contractors want. The IRS should not be in a position to require such a costly rearrangement of business transactions between parties where it is of no, or of relatively de minimus tax consequence to the IRS.

Thank you very much.

Chairman JOHNSON. Thank you very much. Mr. Bryan.

STATEMENT OF SCOTT BRYAN, PRESIDENT, PACIFIC DECORATING CENTERS, ANAHEIM, CALIFORNIA

Mr. BRYAN. Madam Chairman, my name is Scott Bryan. I am president of the Pacific Decorating Centers, a retail business with two locations in Orange County, California.

It is common knowledge that the floor covering industry has been a target of limited IRS employment audits, and, frankly, these audits are not pleasant experiences. I would like to tell you about my

own experience.

In 1988, as an immediate past president of our trade association, I volunteered, as an industry expert, to assist an IRS employment tax specialist working on a project in the State of California to determine what common worker classification practices were being

used in our industry regarding installation.

Because the California EDD, Employment Development Department, had been treating unlicensed installers as statutory employees for State taxing purposes, there was enormous concern that the disparate treatment of these individuals would cause us to become targets for IRS employment tax audits. I shared with the IRS specialist at that time my method of managing this issue and was encouraged to find that my business system of contracts and consistent approach was likely to place me in a very defensive position if, and when, an audit of my business occurred. In retrospect, I was naive in my assumption about this defensible position.

In January 1994, I was notified by the IRS that a full employment audit would be conducted for tax year 1992. We submitted documentation to support our position that State law created this disparate treatment of installers for State and Federal tax treatment. In the alternative, we also submitted a brief to support relief

under section 530.

The result, in December 1994, Christmas never came. Instead, \$447,000 of independent contractor payments on our 1992 forms 1099 were reclassified, leaving us with an approximate \$80,000 tax liability.

If this formula were applied to the 3 years of operations which the Internal Revenue Code permits, our total tax liability would have been over \$200,000, at that time almost two-thirds of my net worth.

We immediately filed a letter challenging the IRS action, and we received no response to our challenge, but 8 months later, in August 1995, a new IRS agent requested a meeting. I was advised that a second investigation of the same audit period was warranted to review potential problems with the initial findings.

Again, a field survey of our installers was conducted, and at that time I refused to go along with an IRS request to sign a consent to extend time for their audit. I made the argument that from that point on, an additional 8 months should be sufficient for the IRS to come to a conclusion. Meanwhile, I continued to maintain no workers were misclassified.

I should not have to tell this Committee that having this openended audit liability created a negative climate for me to conduct my business, and certainly put a pall on any future business ex-

pansion plans.

The IRS examiner called me in December 1995, again requesting me to sign a consent to extend time and telling me my failure to do so would force the Agency to act summarily and in all likelihood to my detriment. I relented and signed a consent, on the condition that I have the opportunity to meet with the agent's supervisor before any final judgment would be made.

In February, 1996, the auditor and supervisor visited my office. I was presented with a newly calculated amount for the individuals IRS claimed were misclassified for 1992, which was now \$390,000, and the approximate tax liability had been reduced to around \$42,000. I advised I would still not accept the findings and would appeal. They said it would be 4 to 6 weeks before I would receive their formal assessment, at which time I would be given my appeal

rights.

Sometime in April, 1996, I received a call from the IRS examiner requesting a meeting to explain a new classification settlement program. Based on the new program, I received a letter reducing the misclassification payments for 1992 to \$246,000, and assessment of \$10,004. The IRS would also agree not to seek further taxes for 1993 through the current 1996 quarter, so long as I reclassified any unlicensed installers as employees for the future.

After conferring with counsel, I notified the IRS that I would accept the offer, thus ending what I will charitably call a difficult and

anxious time for me.

No taxpayer should be put through the ordeal I just experienced. In truth, if I had deep pockets and unlimited patience, I would have taken my case through the appeal process. But, after all, I am just one small business man and simply cannot afford the time nor the continued expense to fight for a principle. My legal and financial costs and personal time spent in this matter far exceeds the IRS' settlement offer. For that matter, the settlement amount in all likelihood exceeds the government's cost in pursuing the matter.

It is time for Congress to resolve the problems surrounding business' use of independent contractors. H.R. 1972 is a good start. Instead of a myriad of subjective judgments, both the private sector

and the IRS would benefit from a more objective standard.

In my case, reflect on how different agents kept coming up with different audit amounts. How just could that system be? As long as you allow it to continue, this issue will be the number one complaint of small business in America. For these reasons we urge support of H.R. 1972. Thank you very much.

[The prepared statement follows:]

STATEMENT OF SCOTT BRYAN OF PACIFIC DECORATING CENTERS

Mr. Chairman:

I am Scott Bryan, President of Pacific Decorating Centers, a retail business with two locations in Orange County, California.

I appear today on behalf of the World Floor Covering Association ("WFCA"), which is the largest trade association representing retail floor specialty firms in America. I am a past President and current member of the Board of WFCA.

I welcome this opportunity to come before the Committee to present the views of the WFCA on a public policy issue that our members consider their number one priority.

Among our member firms, an overwhelming number rely on independent contractors to install floorcovering products sold in our members' stores. This has been an industry practice for as long as there has been an industry. Indeed, during the original debate over Section 530, our industry was active in the campaign to recognize such industry practices.

It is common knowledge that our industry has been a target of limited IRS "employment" audits, and, frankly, these audits are not pleasant experiences. They are made worse because the classification issue is an area of the law that is very subjective and where back tax liabilities and penalties can be overwhelming.

Independent contractors play a crucial role in the American entrepreneurial system. Having acknowledged the legitimacy of the independent contractor role in the U.S. economy and specifically in our floorcovering businesses, we will be the first to condemn the tax evasion among independent contractors, which the IRS has documented. Further, to the extent individuals are misclassified as independent contractors, we deplore the lessening of their rightful employee benefits.

The challenge is to produce a workable formula to assure the payment of Federal tax to the U.S. Treasury, to protect the rightful employee benefits of employees, and to ensure the opportunity for businesses to have independent contractor services available.

Let those of us who play by the rules have the peace of mind and the certainty that we are not at risk when the IRS agent walks through our doors. We deserve no less than that.

Let me tell you about my own experiences, and, then, I think you will understand why I am here today to advocate meaningful reform.

In 1988, I volunteered as an "industry" expert to assist an IRS employment tax specialist working on a project in the state of California to determine what common worker classification practices were being used in our industry regarding installation.

Because the California Employment Development Department had begun treating unlicensed installers as "statutory employees" for state tax purposes, there was enormous concern that disparate treatment of these individuals would become a target for IRS employment tax audits. Accordingly, I participated in a number of industry panels and shared with the IRS specialist my method of managing this issue and was encouraged to find that my business system of contracts and consistent approach was likely to place me in a very defensible position if, and when, an audit of my business occurred.

In retrospect, I was naive. The first challenge to my business practice was an IRS unilateral assessment in 1992 for additional 1989 taxes because the wages being reported to the state of California were higher than those reported to the IRS.

I successfully explained how workers could hold independent contractor status for Federal reporting, but because of state fiat we were required to withhold income taxes if these individuals did not possess a valid State Contractor License. I did prevail in this dispute, citing a joint IRS and Employment Development Department letter in which the agencies conceded that "a worker may be an employee for state employment tax purposes, but not for federal employment tax purposes and vice versa. (November 1990 letter signed by the Director of the California Employment Development Department and the Regional Commissioner of the Internal Revenue Service.)

In January 1994, I was notified by the IRS that an employment audit would be conducted for 1992. At the first conference with the IRS auditor I took the position that our procedures were based upon the professional advice of legal counsel and accountants, and that I had reviewed our procedures with an IRS agent at an earlier time. Following a field survey of our installers by the IRS, the agency formally notified me of an audit in September and requested all employment records, billings, contracts, state and federal tax filings, etc.

We submitted documentation to buttress our position that state law created the disparate treatment of installers for state and federal tax treatment. In the alternative, we submitted a brief to support relief under Section 530.

In December 1994, Christmas never came. Instead, \$447,614 of independent contractor payments on our 1992 Forms 1099 were reclassified, leaving us with an \$80,000 tax liability. If this formula were applied to three years of operations, which the Internal Revenue Code permits, the total tax liability would have been \$200,000 or two-thirds of our net worth.

We immediately filed a letter challenging the IRS action. We received no response to our letter, but eight months later in August 1995, a new IRS agent requested a meeting. I was advised that a second investigation of the same audit period was warranted to review potential problems with the initial findings. Again, a field survey of our installers was conducted. I refused to go along with an IRS request to sign a "Consent to Extend Time" for their audit. I made the argument that eight months should be sufficient for the IRS to come to a conclusion. Mearwhile, I maintained that no workers were misclassified. I don't have to remind this Committee that having this openended audit liability created a negative climate for me to conduct business, and certainly put a pall on any future business expansion plans.

The IRS examiner called me in December 1995, again requesting me to sign a "Consent to Extend Time," and telling me my failure to do so, would force the agency to act summarily, and in all likelihood to my detriment. I relented and signed the Consent on the condition that I have the opportunity to meet with the agent's supervisor.

When the agent called on me again in February 1996, he came without a supervisor, which was a condition for my continued cooperation. Later that month, we did have a meeting with the IRS examiner and his Audit Supervisor in our offices. I was presented with a newly calculated amount for the individuals the IRS claimed were misclassified, which was now \$390,865. The approximate tax liability had been reduced to approximately \$40,000. I advised them I would not accept the findings, and would appeal. They advised that it would be 4-6 weeks before I would receive their formal assessment, at which time I would be advised of my appeal rights.

Sometime in April, I received a call from the IRS examiner requesting a meeting to explain a new classification settlement program. Later that month, I received a letter reducing the misclassification payments for 1992 to \$246,483 and an assessment of \$10,004. The IRS would also agree not to seek further taxes for 1993 through the current 1996 quarter, so long as I reclassified any unlicensed installers as employees in the future.

After conferring with counsel, I notified the IRS that I would accept the offer, thus ending what I will charitably call a difficult and anxious time for me.

Members of the Committee. No taxpayer should be put through the ordeal that I have just experienced. In truth, if I had a deep pocket and unlimited patience, I would have taken my case through the appeal process. But, after all, I am a retailer and simply cannot afford the time nor the continued expense to fight for a principle. My legal costs and the financial costs of my personal time spent in this matter far exceed the IRS settlement offer. For that matter, the settlement amount, in all likelihood, exceeds the government's costs in pursuing the matter.

I believe my own experience reflects the industry experience. There really is no such thing as running a business by a textbook. Business life is full of gray areas. To survive, one has to adjust to realities in the market place. For example, personal security is a consideration if you are dealing with a service provided in the consumer's home. This was not the case a

decade ago. It is important to provide some assurance to the consumer through identification, such as uniforms. Yet, providing such identification is frequently a factor cited in audits in our industry.

The result, in the case of compliance with the so-called 20-point common law test, is that no business can meet all 20 points. And while everyone acknowledges that we are not expected to, there is no real way for the IRS, or us, to figure out which points are the most important, and which are the most relevant to a given situation. It is frustrating for both us and the IRS. In many cases, the 20-point common law test actually requires me to "prove the negative," that is, that I do not control the individual, I do not have the right to fire, and so forth. From the IRS perspective, they are forced to focus on the "tangible" evidence of an employee relationship, although that evidence is hardly a significant indicia of independence.

That is why our organization supports the legislation, H.R. 1972, introduced by Representative Jon Christensen. Its sets forth a simple, three-part test. Instead of "proving the negative," the bill allows me to present affirming evidence to demonstrate the relationship is truly one in which the service provider is an independent contractor.

While I am certain the committee is familiar with it, the key provisions are as follows.

Under part one, the independent contractor must meet just one of the following criteria:

- Have a significant investment in assets and/or training;
- Incur significant unreimbursed expenses;
- Agree to work for a specific time or complete a specific result, and is liable for damages for failure to perform;
- Be paid on a commission basis; or
- Purchase a product for resale.

Under part two, the independent contractor must meet just one of the following:

- Have a principal place of business; Does not primarily provide the service in the service recipient's place of business;
- Pay a fair market rent for use of the service recipient's place of
- Is not required to perform service exclusively for the service recipient and a) has performed a significant amount of service for other persons; b) has offered to perform service for other persons through advertising individual written or oral solicitations such as listing with registries, agencies, brokers, and other persons in the business of providing referrals to other service recipients; or c) provides service under a business name which is registered with or for which a license has been obtained from an appropriate jurisdiction.

Under part three, there must be a written agreement between the parties.

I would also like to address the issue of why Section 530 has not been particularly helpful in our industry. As the Committee knows, Section 530 was a temporary solution. As such, no one anticipated it would have to withstand the test of time.

If there was ever an industry in which the practice of using independent contractors was a long-standing practice of a significant segment of the industry, you would think it would be ours. But yet, we debate this in every audit. What constitutes a significant segment? How do you prove it? There are no bright lines. And, when we ask how to exercise our Section 530 rights, we usually get shrugs from the IRS.

Section 530 has two consistency requirements - that the individual must have never been an employee, and that none of the individuals have performed similar work as employees since 1978. There is no rational reason to maintain these permanent consistency requirements. It is a difficult threshold to meet on a permanent basis, and just as many cases fail on the consistency test as on the substantive industry practice test.

It is time for Congress to resolve the problem surrounding business' use of independent contractors. H.R. 1972, if enacted, would eliminate the problem for my industry. It will clearly level the competitive playing field so that well-run businesses trying to pay their fair share of taxes will not be discriminated against by attempting to meet higher compliance levels than those who operate on the fringe with relatively little fear of a compliance audit. Instead of a myriad of subjective judgments, both the private sector and the IRS would benefit from a more objective standard as in H.R. 1972. Just reflect on how different agents came up with different amounts in my case over the two years that the IRS audited my business. As long as you allow that present system to exist, it will continue to be the number one complaint of small business in America.

I hope you will take the action necessary to correct a problem that has festered for too long. For all these reasons, we urge your support of H.R. 1972.

Chairman JOHNSON. Thank you, Mr. Bryan. Mr. Budzinski.

STATEMENT OF JOHN BUDZINSKI, BUSINESS MANAGER, STEAMFITTERS UNION LOCAL 601, MILWAUKEE, WISCONSIN

Mr. BUDZINSKI. Thank you, Chairwoman Johnson and Members of the Subcommittee. My name is John Budzinski. I am the business manager of Steamfitters Local 601 in Milwaukee, and I am a member of the United Association of Plumbers and Steamfitters of the United States and Canada.

I am not experienced at doing this, and those people that had more experience told me that I should not read my notes to you, but I should talk to you, so I am going to try to do that and do it as briefly as I can.

I have been the business manager in Milwaukee for the last 15 years. My primary mission as business manager is to supply a work force to our contractors that will help them to build the homes, the schools, the pipelines, industry, powerhouses in the city of Milwaukee, the State of Wisconsin, and throughout the Nation.

With that, you might expect I come here to talk to you primarily about the impact of H.R. 1972 on my members, but I am not here to do that. You have written testimony from Bob Georgine, who is more of an expert at those concerns than I am. What I wanted to talk to you about primarily is the impact on my small contractors that this legislation may have.

Along with me, I have senior counsel for the Mechanical Contractors Association of America. They have management, in cooperation with senior counsel John McNerry, who sits on the board of the largest mechanical contractors association in the country, whose primary objective has been to amend or exempt our industry from this legislation.

When I first saw H.R. 1972, I was very pleased to hear that we had some legislation that was going to simplify taxes for all of our contractors and make their life easier, because it is our lifeblood; that is, the contractor. He needs to be a profitable, successful entrepreneur so he can afford to have a skilled work force that works for him. But as we looked further into this legislation, we had some grave concerns.

As you may or may not know, as a skilled tradesman, we must serve apprenticeship of 5 years or in excess of that with continuing education thereafter. It is not unusual for one of our craftsmen to work for more than one employer in any given year. By and large, it is unusual that we work for one employer for more than a year at a time.

Third, it is not unusual for our skilled craftsmen to have a large investment in tools, anywhere from \$2,000 up to \$40,000, or \$50,000, depending on the part of the industry they participate in. All of these would make our skilled craftsmen qualify as independent contractors.

As you may or may not know, the contractors that belong to the MCAA participate in what is called a multiemployer environment. It is because of employment in that environment, that the for education, health care and pension are restricted.

As a regent of the University of Wisconsin, appointed by Governor Thompson, and a member of the board of directors of Vocational Systems in Wisconsin, the cost of obtaining an edu-

cation is very crucial to me.

Throughout our industry, apprenticeship has been a key in continuing education. Those dollars that are used for funding that education come under what is known as Taft-Hartley or ERISA funds, which allow only contributions for employees who could not be accepted on behalf of contractors. This legislation as designed would disallow those contributions, and would stop that educational flow.

Second and third, and as important, the health care system that has been developed by our industry through contractors and labor cooperation has done what the government is talking about doing today. It has provided health care, regardless of employer, regardless of length of employment, and regardless of location of that

employee.

Today, the United Association, across the country through these funds, has established over 400 campuses throughout the country to educate our members, training over 250,000 skilled craftsmen. Again, with the contractors' involvement, we are able to provide health care and pension benefits for hundreds of thousands of members throughout this industry.

For this legislation to pass, and for these funds to be eliminated would cause the government to have to educate the skilled craftspeople that are being skilled by private industry, today and which costs the government and the taxpayers absolutely not one penny. Also we would have to look at how we revamp our health

care for these people.

With these concerns in mind, I would ask you to respectfully look at this amendment, with the intent which we believe is great and good. But it is very important, we believe, for members of the construction industry to be exempt from this H.R. 1972.

I want to thank you for your attention and time on this serious manner.

Thank you.

[The prepared statement follows:]



United Association of Journeymen and Apprentices of the Phunbing and Pipe Fitting Industry of the United States and Canada

LOCAL NO

601

3300 S. 103RD STREET

CITY, STATE, 21

MILWAUKEE, WI 53227

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STATEMENT OF
JOHN BUDZINSKI
BUSINESS MANAGER
STEAMFITTERS LOCAL 601
Milwaukee, Wisconsin
on behalf of the United Association of Journeymen and Apprentices
of the Plumbing and Pipefitting Industry of the

United States and Canada

Before the Ways and Means Oversight Subcommittee
The Honorable Nancy Johnson, Chair
United States House of Representatives

June 4, 1996

To the Honorable Nancy Johnson and Members of the Subcommittee:

Thank you for the opportunity to share serious concerns about the impact of HR 1972.

For almost fifteen years as a business representative of Steamfitters Local 601 in Milwaukee, Wisconsin, it has been my responsibility to work in partnership with business. Our mission is to train and develop the skilled work force necessary to build homes, churches, schools, manufacturing plants, and breweries in and for Milwaukee, Wisconsin and the nation.

Through my work on various international labor/management committees and my service as a member of the University of Wisconsin Board of Regents and member of the State Vocational, Technical and Adult Education Board appointed by Governor Thompson, I can tell you that the experiences I relate to you are important to my colleagues and businesses throughout Wisconsin.

You might expect, as the Business Manager of Steamfitters Local 601, that I would talk with you about the tragic impact of this legislation on the members of the building and construction trades industry, particularly the Steamfitters in Milwaukee. I understand and fully realize how serious this impact will be on the working men and women of the organized trade labor movement. However, there are others who will most appropriately give this testimony.

Instead, it is most important that I share some special insights with you that are based on my experiences in working with the small businesses this legislation seeks to help. It is critical you understand how these small businesses will be affected. It is also critical that you understand how it is possible this legislation will put them out of business. I want to tell you this because this nation as well as members of Steamfitters Local 601 need small businesses to be strong - particularly small construction contractors.

If there is a fact of life that my members and I understand, it is that contractors need to be successful, and if they are to be successful, they must have an efficient, productive work force so they will be profitable. That is why when I first heard that the passage of HR 1972 would result in tax simplification and the reduction of red tape, I was very pleased.

Unfortunately, while this bill as written may have been developed with the strong desire to strengthen the nation by helping business thrive, it will cause havoc with the construction contractors. It is the small contractor who employs a majority of our work force about which we are most concerned. We need these contractors to be strong.

As our members know, the contractor must be profitable to be successful. The contractors and our members in partnership, know that a well trained skilled work force is the lifeblood of our industry. The skilled crafts person is an essential part of the product, service, and profit of the successful contractor.

This legistation destroys the basic structure of apprenticeship training and continued education that has established our skilled work force. This will greatly harm our nation's productivity as well as waste the substantial educational investment contractors have made.

The destruction is brought about because this legislation requires that any employee who receives substantial training from an employer evolves into an independent contractor. Once an employee has been reclassified by this legislation as an independent contractor, there is no reason for business to make investments in education in its work force. Also, whatever investment has been made in employees is

As you may know, these contributions are made in a multi-employer environment. The mechanism for receiving the employer contributions to these trust funds on behalf of the employees was created by congress through the Taft-Hartley and ERISA. These laws specifically prohibit any contribution of funds unless made only on behalf of an maployee. Clearly, the funding for apprenticeship and continued education by contractors will be stopped by force of law and common sense.

Another tragic result is that at a time when there is an increasing shortage of skilled workers, this nation will see its skilled trades resource decimated.

Currently, businesses and skilled trade union organizations work together to initially train and continually deducate tens of thousands of skilled workers. The United Association alone has the largest vocational system in the country. The approximately 400 campuses throughout the United States educates and trains over a quarter of a million skilled crafts people. This education does not cost the taxpayers one penny. The mechanical contractors in Milwaukee alone invest over one million dollars a year for apprenticeships and employee training in this effort. Should this legislation pass as is, there would be no incentive or inducement to continue this outstanding program. People would simply lose out. This country would lose out.

If this nation does not want to lose its leadership in productivity with the rest of the world, millions of additional tax dollars will be needed to replace the training programs now paid for by the labor/management partnerships. Simply stated, should this bill pass, hundreds of millions of dollars of education and apprenticeship training opportunities now privately paid for will be lost. As a nation comporting in a world-wide market there is no justification for destroying one of the great vocational training mechanisms without a suitable alternative.

To pass this bill unamended is to destroy the health insurance and pension trust funds established by business contributions for millions of Americans. These trust funds have proven one of the most cost effective mechanisms for the delivery of health care and pension programs to the worker and his/her family regardless of employer, length of employment, or job location.

As you know, under the Management Relations Act, also known as the Taft-Hartley Act, employers make contributions to employee trust funds. Under the law, these contributions have to be made for the sole and exclusive benefit of "employees", their families and dependents. Because contributions to such multi-employer trust funds can be made only on behalf of "employees", it would be unlawful for the trustees of these funds to accept contributions on behalf of individuals who are considered to be "independent contractors".

Also, under the Employee Retirement Income Security Act of 1974 (ERISA), plan fiduciaries must discharge their duties with respect to a plan solely in the interest of participants and beneficiaries for the exclusive purpose of providing benefits to participants and beneficiaries.

A "participant" under ERISA is any "employee" or former "employee" of an employer who is or may become eligible to receive a benefit of any type from an employee benefit plan. Because the health and pension programs under Taft-Hartley and ERISA would be destroyed, not only would the contractors suffer from the loss, but millions of Americans would lose their health care and pension programs. This nation has spent significant resources attempting to develop health care plans that protect the workers and their families regardless of place of employment. I do not understand the wisdom of this destruction. My only guess is that it is an unintended, unanticipated result of an attempt to help small business.

This issue is so important that the Mechanical Contractors Association of America, the largest mechanical contractor's association in the United States representing approximately 1,800 contractors, has deemed the defeat of this legislation as its #1 legislative priority.

On behalf of small business contractors and hundreds of thousands of skilled crafts people and their families, I urgently and respectfully request that an amendment be adopted exempting the construction industry from this legislation.

I thank you for your dedicated attention to this most serious matter.

Chairman JOHNSON. Thank you very much, Mr. Budzinski. You pointed out some impacts that we would share your concern about. We will look at that very carefully.

Mr. Kane.

STATEMENT OF RAYMOND PETER KANE, PRESIDENT, PISA BROTHERS TRAVEL SERVICE, NEW YORK, NEW YORK

Mr. KANE. Madam Chairman, it is an honor and a privilege for me to appear before the House Ways and Means Subcommittee on Oversight today. I applaud the Subcommittee's efforts for holding this hearing, and I ask that my full statement be made part of the Subcommittee hearing record.

I am pleased to have the opportunity to comment on the independent contractor issue and the two bills before the Subcommittee. This legislation would have a positive impact on the thousands

of travel agency owners across this country.

My name is Raymond Peter Kane. The name of my travel agency is Pisa Brothers Travel Service, which is located in New York City and was founded in 1924. I have owned and managed the agency since 1962. I also come before the Subcommittee today as a long-standing member of ASTA, American Society of Travel Agents. ASTA is the world's largest and most influential travel trade association with over 28,000 members—

Chairman JOHNSON. Excuse me. It would be helpful if you could pull your microphone slightly closer.

Mr. KANE. ASTA is the world's largest and most influential trade

association, with over 28,000 members in 168 countries.

Our members in the United States represent some 13,000 travel agency locations. Sixty percent of the agencies are owned by women, many of whom started as independent contractors, which enabled them to have their own businesses and accumulate the capital necessary to own an appointed travel agency. Eighty percent of travel agency employees are women. Ninety percent of our members employ less than 10 people.

A majority of the travel agencies in the United States utilize the services of independent contractors. Over the years, agents have received mixed decisions from Federal and State tax auditors as to the status of their independent contractors. Since we are clearly small business men and women, we have had little or no recourse

to challenge those audits.

In the seventies, in accordance with a widespread industry practice, Pisa Brothers began renting space to independent contractors in exchange for a percentage of the commissions that they earned from the travel bookings of their clients. This enabled these entrepreneurs to set themselves up in business without a large capital investment and enhance the earnings of my travel agency. During all of this time, we have scrupulously issued 1099s, reporting all income of the independent contractors to the Internal Revenue Service, and have abided by every one of the 20 guidelines that the IRS issued.

Pisa Brothers offers three different contracts to independent contractors. They are as follows: One, if a contractor wants Pisa Brothers to book and process reservations for the contractor's clients,

Pisa Brothers charges 70 percent of the commissions earned by those transactions.

Two, if a contractor wants to make reservations for his or her own clients and have Pisa Brothers process the reservations, then Pisa Brothers charges 50 percent of the commissions earned by those transactions.

Three, if a contractor wants to rent a desk on Pisa Brothers premises, book and process his or her own client reservations, then Pisa Brothers charges either 40, 35, or 30 percent of the commissions earned by those transactions, depending on volume.

In August 1991, I received a notice from the IRS that they wanted to conduct an income tax audit for the fiscal year 1989. This audit took place over a period of several months and resulted in a finding on February 18, 1992, of no change, which, as you know, means that the auditor found nothing wrong.

During this 6 months that the IRS auditor was in my office, the contracts between my agency and independent contractors were carefully scrutinized and found to be in compliance with the IRS regulations regarding independent contractors as indicated by the no change finding.

Two years later, with no change in the IRS rules and no change in my contracts with the independent contractors, the IRS has decided that these same independent contractors were not independent contractors all along and were always employees. For the years 1992, 1993, and 1994, the IRS is demanding \$274,000 in taxes and penalties.

IRS denied the section 530 coverage because they said I did not meet the consistency requirement. The IRS chose to ignore the fact that the house agents handled only house accounts, and independent contractors handled only their own accounts.

In other industries they have recognized that people with the same titles can perform completely different duties and can be independent contractors, but in the travel industry, in my case, they are choosing to completely ignore this by stating that all travel agents must be employees. How can you defend yourself against actions like this when the findings of the IRS on such an important matter can vary from one individual IRS agent to another?

In my industry, independent contractors are the most productive people. They are typical of small business people who will go to any lengths to satisfy their customers to build their following because this is their livelihood. Actually, the IRS probably collects more tax revenue due to the existence of these private contractors than if the same people were regular employees doing a routine job without the incentives that come from private ownership of their own business.

There is also a moral question here. These people have the right to be independent contractors. The IRS wants to deny them this right, not because they are not paying their taxes, but because it is easier for the IRS to monitor their payments as employees. If the IRS has a compliance problem collecting taxes from independent contractors, it should deal with this problem on its own merits and not try to change it to a classification problem in order to deny these people their right to be entrepreneurs simply for the convenience of the Internal Revenue Service.

In light of the recent actions taken by the major air carriers to cap travel agent commissions, this effort to simplify the definition of an independent contractor will be vital to us as more and more travel agencies look toward independent contractors to develop additional sources of revenue.

In conclusion, I hope you will support Congressman Christensen's bill, H.R. 1972. In my opinion, it is drafted in such a way as to provide the best protection for independent contractors. It clearly states the criteria that must be met to be classified as an independent contractor. This is so important if we are to remove the current confusion in the marketplace.

Thank you. I would be delighted to answer any questions you or the Subcommittee Members may have at this time.

[The prepared statement follows:]

STATEMENT OF RAYMOND PETER KANE OF PISA BROTHERS TRAVEL SERVICE

Madam Chairman, it is an honor and a privilege for me to appear before the House Ways and Means Subcommittee on Oversight today. I applaud the subcommittee's efforts for holding this hearing and ask that my full statement be made part of the committee hearing record. I am pleased to have the opportunity to comment on the independent contractor issue and the two bills before the Subcommittee. This legislation would have a positive impact on the thousands of travel agency owners across this country.

My name is Raymond Peter Kane. The name of my travel agency is Pisa Brothers Travel Service which is located in New York City and was founded in 1924. I have owned and managed the agency since 1962. I also come before the Subcommittee today as a long-standing member of the American Society of Travel Agents (ASTA).

ASTA is the world's largest and most influential travel trade association with over 28,000 members in 168 countries. Our members in the U.S. represent some 13,000 travel agency locations. Sixty percent of the agencies are owned by women, many of whom started as independent contractors which enabled them to have their own businesses and accumulate the capital necessary to own an appointed travel agency. Eighty percent of travel agency employees are women. Ninety percent of our members employ ten or less people. A majority of the travel agencies in the United States utilize the services of independent contractors. Over the years, agents have received mixed decisions from federal and state tax auditors as to the status of their independent contractors. Since we are clearly small businessmen and women, we have had little or no recourse to challenge those audits.

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The IRS denied the Section 530 coverage because I did not meet the consistency requirement. The IRS chose to ignore the fact that the house agents handle only house accounts and independent contractors handle only their own accounts. In other industries they have recognized that people with the same titles can perform completely different duties and can be independent contractors, but in the travel industry, in my case, they are choosing to completely ignore this by stating that all travel agents must be employees.

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Thank you. I would be delighted to answer any questions you or the Subcommittee members may have at this time.

Chairman JOHNSON. Thank you, Mr. Kane, for your testimony. Ms. Kelley.

STATEMENT OF LAURADAY KELLEY, PRESIDENT, ASSOCIATION OF RETAIL TRAVEL AGENTS, AND VICE CHAIRMAN, COALITION FOR TRAVEL INDUSTRY PROFITABILITY, HARRISBURG, PENNSYLVANIA

Ms. Kelley. Thank you, Madam Chairman. Thank you Members of the Subcommittee.

On behalf of the Nation's travel agents, travel agencies, and all other service providers and recipients in the travel industry, I appreciate the opportunity to appear before you today to testify on the issue of IRS treatment of independent contractors. I ask that my full statement be made part of the Subcommittee hearing record.

My name is Lauraday Kelley and I am vice chairman of the Coalition of Travel Industry Profitability and president of ARTA, the Association of Retail Travel Agents. The Coalition for Travel Industry Profitability is a proactive travel industry group that was formed in January 1995 by 23 major travel cooperatives representing over 23,000 travel agencies and their agents, a significant percentage of whom are independent contractors.

ARTA, which is part of CTIP, represents 3,500 travel agents around the United States. I am delighted to appear today with some of my industry colleagues to share our views with Congress on why we must work together to protect the rights of the independent contractors, as well as the rights of the service recipients.

Madam Chairman, I can tell you and the other Members of the Subcommittee that without a doubt, the issue of the IRS treatment of independent contractors is one of the most important issues affecting our industry today.

As you know, travel agents have never received consistent opinions from either Federal or State revenue collectors as to their independent contractor status. Typically, the arcane, 20-factor test combined with a broad and arbitrary interpretation of the safe harbor provision of section 530 of the Code have placed an incredible hardship on businessmen and women.

Travel agencies are typically small business and predominantly women-owned. When a call comes from the IRS, they cannot turn to their team of in-house attorneys for advice and counsel. Regardless of whether they are right or wrong, very few travel agents have the financial wherewithel to challenge the IRS.

have the financial wherewithal to challenge the IRS.

This morning, I would like to focus my remarks specifically on a situation that travel agents and travel agencies face today. Time limitations do not allow me to tell you about the hundreds of horror stories I have heard from my members. However, I would like to tell the Subcommittee of one particular erroneous episode which represents the experience of many.

Compass Point Travel in Mountain View, California, is a small agency who since the 1980s, has employed both full-time agents and a number of independent contractors. These independent con-

tractors have a signed contract with the agency.

The owner of the agency is extremely knowledgeable in the rules and requirements of the IRS independent contractors. In fact, she

participated in a debate on the feasibility of independent contractors in the travel industry for which she did extensive research on the subject.

In the fall of 1986, Compass Point Travel was audited by the State of California, after months of discovery, legal fees and lost revenue, Compass Point Travel won their case. The State appealed,

but Compass Point Travel again beat them on appeal.

Then, one year ago, to the owners' amazement, Compass Point Travel received notification that they were now being audited by the United States Internal Revenue Service. The grueling exercise

began all over again.

Again, after months of enduring the IRS audits, the IRS attempts at intimidation, more legal fees and more lost revenues, Compass Point Travel was advised they did not owe the IRS. All the while, Compass Point Travel was never actually advised that they were either in violation or not in violation of the current IRS code. As of today, they still have not been advised.

Madam Chairman, although Compass Point Travel had a positive decision, the expense, time and aggravation experienced clearly demonstrates the untenable situation for travel agencies and travel agency owners. On both the State and Federal level, there is no clear interpretation of the law as it relates to independent

contractors.

Indeed, the current independent contractor law is so vague, it literally leaves the interpretation up to the whims of the individual auditor, which can only invite the type of horror stories I relayed to the Committee today, and I hear on a daily basis.

Travel agents are typically the smallest of the small service recipients. Our independent contractors are extremely vulnerable. The IRS clearly has an emphasis on "they are small, scare them,

and they will pay" attitude.

America was built by small entrepreneurs, and in the travel agency community, there are more than 425,000 sellers of travel. These people cannot and should not be forced to classify themselves as employees, particularly when the trend today is toward homebased businesses. Nor can these small business employers who work on a very small profit margin afford to reclassify their independent contractors as employees. For many, such a decision will push them into bankruptcy.

For countless numbers of travel agencies that have experienced independent contractor issues with the IRS, the Coalition for Travel Industry Profitability strongly endorses Congressman Christensen's bill, H.R. 1972. I might also add, we were delighted that Congressman Christensen agreed to support report language that removes any possible interpretive ambiguity on the part of the IRS and will help ensure the IRS will follow the letter and spirit

of H.R. 1972.

Specifically, the report language makes it unmistakenly clear that although all three tests in the bill must be met to be considered an independent contractor, only one or more of the conditions within each test is needed to comply. For example, if a travel agency meets the requirement that its independent contractors rent space at a fair market value as provided in subsection (c)(1)(C), the agent need not have to comply with subsection (c)(2)(A), which pro-

hibits the service provider from performing the services exclusively for the service recipient. Due to the nature of the travel agency business, travel agencies have exclusivity contracts with their agents. Although H.R. 1972's language may seem legally straightforward, past experience with the IRS leaves us to believe that additional assurances are certainly necessary.

I have included a copy of the recommended report language in my testimony. I urge all Members of the Subcommittee to support

this important language.

Madam Chairman, this concludes my remarks, and I thank you for the opportunity to be able to share my thoughts with you today.

I am happy to answer any of your questions.

[The prepared statement and attachment follow:]

STATEMENT OF LAURADAY KELLEY OF COALITION FOR TRAVEL INDUSTRY PROFITABILITY AND ASSOCIATION OF RETAIL TRAVEL AGENTS

Thank you Chairman Johnson and Members of the Subcommittee. On behalf of the nation's travel agents, travel agencies and all the other service providers and recipients in the travel industry, I appreciate the opportunity to appear before you today to testify on the issue of IRS treatment of independent contractors. I ask that my full statement be made part of the Committee hearing record. My name is Lauraday Kelley and I am the Vice Chairman of the Coalition for Travel Industry Profitability (CTIP) and President of the Association of Retail Travel Agents (ARTA).

The Coalition for Travel Industry Profitability is a proactive travel industry group that was formed in January of 1995 by 23 major travel cooperatives representing over 23,000 travel agencies and their agents, a significant percentage of whom are independent contractors. ARTA, which is part of CTIP, represents 3,500 travel agents around the U.S. I am delighted to appear today with some of my industry colleagues to share our views with Congress on why we must work together to protect the rights of the independent contractors as well as the rights of the service recipients. Madam Chairman, I can tell you and the other Members of the Subcommittee that, without a doubt, the issue of the IRS treatment of independent contractors is one of the most important issues affecting our industry today.

As you know, travel agents have never received consistent opinions from either federal or state revenue collectors as to their independent contractor status. Typically, the arcane 20-factor test, combined with a broad and arbitrary interpretation of the Safe Harbor provisions in Section 530 of the code have placed an incredible hardship on businessmen and women. Travel agencies are typically small businesses and predominantly women-owned. When a call comes from the IRS, they can't turn to their team of in-house lawyers for advice and counsel. Regardless of whether they are right or wrong, very few travel agents have the financial wherewithal to challenge the IRS.

This morning, I would like to focus my remarks specifically on the situation that travel agents and travel agencies face today. Time limitations today do not allow me to tell you about the hundreds of horror stories I have heard from my members. However, I would like to tell the Committee of one particularly onerous episode which represents the experiences of many.

Compass Point Travel in Mountain View, California, is a small agency who, since the early 1980's, employed both full time travel agents and a number of independent contractors. These independent contractors have a signed contract with the agency. The owner of the agency is extremely knowledgeable in the rules and requirements of the IRS for independent contractors. In fact, she participated in a debate on the feasibility of independent contractors in the travel industry for which she did extensive research on the subject. In the fall of 1986, Compass Point Travel was audited by the State of California. After months of discovery, legal fees and loss of revenue, Compass Point Travel won their case. The state appealed, but Compass Point again beat them on appeal.

Then, one year ago, to the owners' amazement, Compass Point Travel received notification that they were now being audited by the U.S. Internal Revenue Service. The grueling exercise began all over again. Again, after months of enduring the IRS audit, the IRS's attempts at intimidation, more legal fees and lost revenue, Compass Travel was advised that they did not owe the IRS. All the while, Compass Travel was never actually advised that they were either in violation or not in violation of the current IRS code.

Madam Chairman, although Compass Travel had a positive decision, the expense, time, and aggravation experienced clearly demonstrates the untenable situation for travel agents and travel agencies. On both the state and federal level, there is no clear interpretation of the law as it relates to independent contractors. Indeed, the current independent contractor law is so vague, it literally leaves the interpretation up to the whims of the individual auditor, which can only invite the type of horror stories I relayed to the Committee today, and I hear on a daily basis.

Travel agents are typically the smallest of the small service recipients. Our independent contractors are extremely vulnerable. The IRS clearly has an emphasis on a "they're small, scare them and they'll pay" attitude. America was built by small entrepreneurs, and in the travel agency community there are more than 425,000 sellers of travel. These people cannot and should not be forced to classify themselves as employees, particularly when the trend today is toward home-based businesses. Nor can these small business employers, who work on a very slim profit margin, afford to reclassify their independent contractors as employees. For many, such a decision will push them into bankruptcy.

For the countless number of travel agencies that have experienced independent contractor issue with the IRS, the Coalition for Travel Industry Profitability strongly endorses Congressman Christensen's bill, HR 1972. I might also add that we were delighted that Congressman Christensen agreed to support report language that removes any possible interpretive ambiguity on the part of the IRS and will help ensure that the IRS will follow the letter and spirit of HR 1972.

Specifically, the report language makes it unmistakably clear that although all three tests in the bill must be met to be considered an independent contractor, only one or more of the conditions within each test is needed to comply. For example, if a travel agency meets the requirement that its independent contractors rent space at a fair market value, as provided in subsection (c) (1) (C), the agency need not have to comply with subsection (c) (2) (A), which prohibits the service provider from performing the services exclusively for the service recipient. As you may know, most travel agencies have exclusivity contracts with their agents. Although HR 1972 language may seem legally straight forward, past experience with the IRS leads us to believe that additional assurances are necessary.

I have included a copy of the recommended report language in my testimony. I urge all members of the Committee to support this important language.

Madam Chairman, this concludes my remarks. Thank you for the opportunity to be able to share my thoughts and experiences. I will be happy to answer any questions from the Committee.

Report Language Clarifying the Treatment of Travel Agents under The Independent Contractor Tax Simplification Act of 1996,

HR 1972

The Committee wishes to emphasize that the requirements of subsection (c) will be met if any one of the three factors are present. Therefore, a service provider will be classified as an independent contractor under the bill even though the service provider is required to perform service exclusively for the service recipient, if, for example, the service provider pays a fair market rent for use of the service recipient's place of business and otherwise meets the requirements of subsections (b) and (d). As a result, the bill will cause workers who may work full-time for a particular service recipient to be classified as an independent contractor. For example, although travel agents typically work out of the travel agency's office and are required to sign exclusivity agreements with these travel agencies, they often pay fair market rents. However, travel agents perform a personal service from which they develop a client base and are compensated by commission income derived from third parties. Therefore, travel agents, who may have an exclusive agreement with a particular service recipient, are not controlled by the service recipient because of the highly personal nature of the services performed.

Chairman JOHNSON. I thank the panel for your testimony this morning. It is very helpful to have your experience as we approach the responsibility to clarify the independent contractor law.

Thank you, Mr. Budzinski, for your comments to raise concerns

about possible impacts that we may otherwise not be aware of.

Dr. Meek, your experience has a unique significance because your experience is applied to school districts throughout the Nation. It will divert a very significant number of educational dollars from our children.

It is also true that the need for specialized transportation services in communities is increasing and independent bus contractors are one of the few sources that many communities have to meet the intermittent transportation needs of special populations. So, it would be a loss to society for all those buses to be owned by the school department, as well as create costs and problems for school systems.

Are there any liability problems in the current relationship you

have with your bus drivers?

As you point out, there are approximately 13,000 bus districts across the country. I believe the vast majority of them have the contractual arrangements I described with Talbot County, Maryland. Although, there are a few States that do have all of their drivers as employees on a statewide basis.

I agree with your assessment. I think the contractor arrangement provides for greater flexibility. Many of these contractors in fact operate these buses as family operations and have other jobs that they also do, including farming and other kinds of businesses.

The 40-year experience in Talbot County suggests that there are no liability issues that would significantly deter my recommendation to you to continue to see bus contractors operate in the manner in which they have successfully operated for 40 years or more.

Mr. Matsui.

Mr. MATSUI. Thank you.

Mr. Bryan, again, you raised some very important issues, then you outline the bill that Mr. Christensen introduced, H.R. 1972. Actually, you have the right interpretation of it; you raise the three

points, and you have the conditions in the disjunctive.

I guess my concern is if, in fact, the Christensen bill as it is written, passes, we would not even have to talk about independent contractors, because you can almost have any employment relationship be an independent contractor relationship. So, I am assuming you are flexible in the sense that the legislation will be modified and you expect it to be modified if in fact we do do something legislatively in this area; is that correct? Or is this the position that you feel that there only should be three criteria, and there should be only one condition out of those three criteria, and, therefore, you basically change a lot of employment relationships.

Will you explain to me? You raise a specific issue that I think

is legitimate.

Mr. BRYAN. I was invited here, Mr. Matsui, to basically tell my personal experience. I am an expert only in my industry. I do not profess to know everything about every other industry this might affect. I said in my testimony I think this bill is a good start, we all are familiar with the expression "if it ain't broke, don't fix it."

I think in this case, the existing policies as written "are broke." So, they need to be fixed.

I am not sure that H.R. 1972 is the perfect answer, but I am in favor of a movement toward a little more free economy or free mar-

ket system in this aspect.

I think the key point in Mr. Christensen's bill is the contract says an awful lot. That is the third requirement and most important qualification in my mind. I think that the independent contractor status is a stepping stone from being an employee to being a full-fledged larger businessowner. You need that stepping stone.

In our industry the first step from an installer, who is employed by someone directly and gets all his tools furnished to him, is, he goes out and buys his own truck and tools and prints some business cards, and in our case, he gets a State contract license and sets himself up as a contractor. Then he becomes a businessman.

I see nothing wrong with allowing him to do that.

Mr. MATSUI. Let me say this. For all of the people here today, if in fact the intent is to try to deal with problems you have described and the last panel described, I am with you. I think we need to deal with these issues. There is a lot of ambiguity in the law, and certainly the Internal Revenue Service can interpret it any way they want, and there is so much leeway that it creates tremendous dangers for all of you.

I think the gentleman who dealt with the cable industry on the

last panel, all of you have raised some legitimate issues.

But if your intent is to support 1972, which basically would make major changes in the relationship between employer-employee, to the point where my interpretation about this airline employee would in fact be possible, then you lose me. Then I am not interested in working with any of you, because basically it is an attempt to try to make sure that you bring these people on and you disturb the employment relationship so benefits do not have to be paid, like pension benefits, health care benefits, minimum wages and things of that nature. That is not what you are talking about.

I would just urge all of you to be careful about what you are supporting, because this latter bill, 1972, would have that latter impact. So, we want to help with your problems, because I think you

raise legitimate issues.

Mr. Meek, for example, that is a very tough issue. I think you started with these people as independent contractors over the years, 40 years, whatever it may happen to be, very legitimate, and then now you have a situation where some of these folks have their own buses and some do not. The Service is trying to interpret your entire operation. I think you have a very legitimate concern there.

I wouldn't want to get into the factual details as to whether it should be an employment relationship or an independent contractor relationship, because obviously there are a lot of facts. But you cannot be left in a situation where all of a sudden they are trying to get a couple hundred thousand dollars from a school district that probably is basically making it now. The same applies to all of you.

But those issues should be addressed. We have an obligation to address them. But I can guarantee you that some of us will not be particularly interested in attempting to find legislation that would allow employment relationships, employers particularly, with the

downsizing going on in this country and the insecurity of the average employee, to all of a sudden find themselves in a position where they are loosing valuable benefits like health care and pension benefits.

Under Mr. Christensen's bill, you can make a lot of cases where currently traditional employment relationships, that you would all agree to, all of a sudden could become independent contractor relationships. So, I just urge you to read the legislation before you endorse this bill, because it does have some significant concerns.

Ms. Kelley. Mr. Matsui, I have two things: One, I agree with what you are saying, but in view of all the downsizing that has taken place in this country today, there are thousands and thousands of people out of work, looking for employment. These people have become small entrepreneurs and many have become independent contractors and have hired themselves or contracted with other independent contractors. So, it is another end of the industry that is developing, and particularly with the emphasis on home-based businesses and two family members working, it has become a given that it is easier for two members of a family, at least one of them work out of their home. That becomes an independent contractor situation.

Mr. MATSUI. I agree with you. I think we need to try to address those issues, but we need to make sure there is a balance as well.

All of us agree on that goal.

Ms. Kelley. One other point. When we are talking about the problem that lies with the IRS not understanding, and not executing their duties properly, well, is it far easier to teach the current IRS personnel behavior modification, or to understand very thoroughly three rules with subtitles, as opposed to the 20-point test we have now? That is my only other comment.

Mr. MATSUI. Let me just address that. I know we want to end this panel, but the problem with these three rules, these tests here, is the fact that all you need to do is pick one out of the five conditions under the first criteria, one out of the four, and then obvi-

ously a written contract.

The danger you face there is you can almost make anybody an independent contractor in this kind of interpretation. That is where you have to be careful. Because you have some businesses exploit the work force, because obviously the big issue, we all know this, the big issue in terms of labor negotiations now are health care benefits, pension benefits, non-wage benefit issues. And we do not want to put a camel's nose under the tent where all of a sudden you are going to have a lot of people, more people than there are today, without these kinds of benefits.

I am just trying to assure everyone that I wanted to work with the specific issues and try to gain greater certainty in the relationship. But I will not participate if this is an attempt to try to destroy the employment relationship under current traditional employer-employee relationships now, to try to take away the benefits that many people are receiving

fits that many people are receiving.

Mr. BRYAN. Mr. Matsui, I think I can help you out a little with the analogy you used with the airline pilot. I do not propose to answer how Congressman Christensen would answer. But that airplane is an extension of that business's place of work. I clearly

think that he would have a tough time holding that job as an independent contractor, even under the restrictions of Congressman Christensen's bill.

But I am in agreement with you, in that I think we all see this as a start. I am looking for some consistency and some clear-cut definition. I think that is the message that is coming across here. Because what holds me back in my business is I have to make a decision; do I have an entire work force of just independent contractors, or do I have an entire work force of employees? It makes it very difficult in our industry. If you dare mix the two on the same premises or in the same business, you are inviting disaster.

The only reason we prevailed in the end is because we stayed strict to a specific program for 12 years. I still had a battle. But if you would allow a business through this bill or one very similar to at least have clear-cut guidelines as to who is an employee and who isn't, and then have it well-defined by a contract between the businessowner and the independent contractor, I do not think you would have a problem.

The real problem is with collection of revenue, I see the argument against this bill, but I think the real problem with collection of revenue is that you would actually receive more revenue, because in my industry the decision faced by the less scrupulous businessmen is do I completely ignore the law and run the risk of an audit and run and hide if it ever happens, or do I become a legitimate businessman and grow my business the right way and follow the law?

Too many people stay below that radar screen, and it causes headaches for us, it creates a lot of problems in the industry, and if a businessman could be faced with a clear-cut set of rules that he could grow his business under, I think you would have our industry flourishing and probably many others, and good legitimate use of legitimate subcontractors that are paying their taxes.

I would like to see the Congress concentrate more on compliance and maybe tracking the revenue movement. If the IRS was serious about solving the underground economy problem, they wouldn't allow these check-cashing stands on every corner, that if you cash a check for under \$10,000, there is no microfilm trail. This is what allows bandit dealers in my industry to cause us havoc. The IRS will not go after them because they know there is no paper trail to collect revenue.

Mr. MATSUI. I thank you.

Mr. BRYAN. I didn't see the red light go on.

Chairman Johnson. I thank the panel for your testimony here this morning. I think you will remember that Congressman Christensen in his testimony made the point that the IRS ought to be neutral in regard to these relationships; that people ought to have the right to be an independent contractor, but we shouldn't prejudice the benefits so that employers are encouraged to move employees into an independent status against their interests and against their will.

So, we do want a balanced law. You have brought forward some very serious problems and given us vivid examples of how the current law is not working and have raised very significant questions that need to be addressed in this session, and we will be working to achieve that goal.

Thank you very much.
[Whereupon, at 12:12 p.m., the hearing was adjourned, to reconvene on Thursday, June 20, 1996, at 10:38 a.m.]

EMPLOYMENT CLASSIFICATION ISSUES

THURSDAY, JUNE 20, 1996

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON OVERSIGHT,
Washington, DC.

The Subcommittee met, pursuant to call, at 10:38 a.m., in room 1100, Longworth House Office Building, Hon. Nancy L. Johnson (Chairman of the Subcommittee) presiding.

Chairman JOHNSON. The hearing will come to order.

Today the Subcommittee will continue its examination of issues relating to the classification of workers as employees or independent contractors for Federal tax purposes.

For over two decades, Congress, the administration, and the Nation's employers and workers have struggled to make sense of the ambiguities and complexities in the common law 20-factor test governing the status of workers. I would hazard that probably no other area of the law has remained so unclear for so long.

The Congress believes that it is appropriate to provide interim relief for taxpayers who are involved in employment tax status controversies with the IRS and who potentially face large assessments as a result of the Service's proposed reclassification of workers until the Congress has adequate time to resolve the many complex issues involved in this area.

This is a sentence from the explanation of provisions in the Revenue Act of 1978 establishing the section 530 safe harbor. Who would have dreamed we would still be trying to resolve those many complex issues today?

The primary impetus for our hearing is to address the concerns being expressed by small businesses across the Nation that the

IRS' efforts to reclassify workers is causing hardship.

In 1988, the IRS established its ETEP, Employment Tax Examination Program which target small businesses with assets of \$3 million or less for audits on the classification of their workers. Since 1988, IRS has conducted over 13,000 ETEP audits, recommending over \$830 million in taxes and reclassifying 527,000 workers. It is little wonder that the call for a bright-line objective test to distinguish between employees and independent contractors was ranked as the number one legislative priority in last year's White House Conference on Small Business.

In our continuing quest to find that line, the Subcommittee will hear today from the Treasury Department, the IRS, the GAO, tax practitioners, and witnesses from the private sector.

We want to welcome Don Lubick back to the Ways and Means Committee here today, representing the Treasury Department,

once again after a 16-year absence.

IRS Commissioner Peggy Richardson is also here to discuss the Service's worker classification initiatives. I want to take this opportunity to commend Commissioner Richardson and the IRS for the steps the Service has taken under her direction to bring greater clarity to this difficult area.

After participating in the White House Conference on Small Business last year, Commissioner Richardson pledged that IRS employees would be retrained to better understand and apply the factors used to classify workers for tax purposes. Following up on the pledge, for the first time ever, IRS published its revised training materials for comment. This is a significant and positive first step on the IRS' part and reflects fine leadership by the Commissioner.

Unfortunately, even the IRS cannot make a silk purse out of a sow's ear, and that is exactly what the common law 20-factor test is. I sincerely hope that the Subcommittee's probe of this issue will lead to a renewed commitment to work together on a bipartisan

basis to forge a lasting solution to this difficult problem.

Congressman Gilchrest is with us as our first witness, and it is, indeed, a pleasure, Congressman, to welcome you to the Ways and Means Committee because you are a Member reputed in this body for thoughtful and knowledgeable comments, and I look forward to your comments on this difficult subject this morning. Welcome.

Mr. GILCHREST. Thank you very much, Madam Chairman.

Chairman JOHNSON. Oh, excuse me. Before we start, I had forgotten that I want to yield.

Mr. KLECZKA. Slight procedure, Madam Chairman.

Chairman JOHNSON. Yes. I want to yield to Mr. Kleczka who is filling in as Ranking Member this morning for Mr. Matsui.

Mr. Kleczka.

Mr. KLECZKA. Thank you, Madam Chairman.

Congressman Gilchrest, you do not mind waiting a couple of min-

utes, do you?

Today is the Oversight Subcommittee's second hearing on the controversies surrounding classification of workers as employees or independent contractors. The witnesses scheduled to appear before the Subcommittee today will include experts on the issue, as the Chairwoman indicated, from the Department of Treasury, Internal Revenue Service, the U.S. General Accounting Office, the American Bar Association, and the New York State Bar Association.

All of us look forward to hearing their views on what should and should not be done in the area of worker classifications. Particularly, it is important the record reflect the adverse impact that shifting to independent contractor status will have on millions of workers who work long and hard such days or a maleuse.

workers who work long and hard each day as an employee.

As a result of our first hearing on June 4, 1996, I think it would be fair to say that something needs to be done in the area of worker classifications. We should continue our discussions on a bipartisan basis.

The proposals currently pending before Congress are much too broad and would allow for wholesale reclassifications of workers as independent contractors. A legislative solution will not be simple. The business community does not speak with one voice on whether or what changes should be made to current law. Something narrowly targeted should be considered by the Subcommittee in a way that balances both the interests of small business and employees.

And last, before Congress adopts any new worker classification rules, the nontax society benefits of employee status should be thoroughly explored to ensure that workers do not unintentionally lose pensions, health insurance and other fringe benefits, unemployment compensation, and other worker workplace protections.

I know we all look forward to receiving the testimony of the IRS by Commissioner Richardson. She has done a great job of taking the bull by the horns and implementing several very positive initia-

tives to deal with the controversy of worker classifications.

She, like all of us, recognizes that the IRS' handling of employment tax audits has serious problems and as a result has initiated important administrative reforms such as the new audit training manual, more auditor training, the Multi-Tiered Settlement Offer Program, and an expedited examination appeals process. While maybe not perfect, her actions are obviously a step in the right direction.

I want to also welcome the new Assistant Secretary for Tax Policy, Mr. Don Lubick, to the Oversight Subcommittee. I should note that last week as a part of its markup on the Small Business Job Protection Act of 1996, the Senate Finance Committee adopted Senator Nickle's narrow package of amendments to provide several clarifications to the application of section 530 relief.

Ranking Subcommittee Democrat Bob Matsui is not able to be here today. However, I know he has talked with many of the witnesses in advance of the hearing and will provide an opening statement for the record. Both he and I are very interested in this issue and will continue to be active participants in the workings on its Subcommittee and on the Full Committee.

Finally, I am pleased that the Subcommittee's witness list and hearing record will provide a balanced discussion on the issue before us.

Thank you, Madam Chairman.

Chairman JOHNSON. Thank you very much.

And now, Mr. Gilchrest.

STATEMENT OF HON. WAYNE T. GILCHREST, A REPRESENTA-TIVE IN CONGRESS FROM THE STATE OF MARYLAND

Mr. GILCHREST. Madam Chairman, I do think currently there is pending legislation to determine the best uses for sows' ears in the Agriculture Committee. I am not sure how that will turn out, but we hope for the best.

I also would like to recommend for the Interior Committee to have these kinds of water pitchers. I think they are very nice. I wouldn't recommend them for Federal courthouses, however.

Madam Chairman and Members of the Subcommittee, I would like to thank you for the Subcommittee's indulgence. I know that the testimony on this for Members was actually on June 4, but I was unable to be in Washington at that time. So, I appreciate the opportunity to do this.

I am aware that the Subcommittee has already received testimony from Dr. Sam Meek, Superintendent of Talbot County Schools, and my testimony is meant primarily to add emphasis to what he said.

In Maryland, as in many other States, it is a common practice for school boards to contract out their schoolbusing services to self-employed individuals. I myself during the course of my college years spent 4 years driving a schoolbus, and I can tell you, as I will say later in my testimony, there is a very distinct difference between driving children with special needs and driving children that go to regular schools and do not have those special needs. So, I wanted to make that point clear early on because the IRS, I think, in determining their Tax Code needs to understand that there is a very big distinction between the type of training and the type of responsibility and the type of things people need to do under those circumstances.

Nearly every school district on the Eastern Shore has operated under such an arrangement as independent contractors for many, many decades, and everybody over there is very happy with it. Recently, however, this contractual arrangement has come under scrutiny from the IRS, and that agency has made the determination that under the common law test currently used to determine contractor status, these schoolbus drivers had to be considered employees. This determination has been particularly disruptive for the affected counties.

The IRS is currently assessing several counties for back payroll and other taxes, and the school districts are considering several options, none particularly desirable, for addressing this problem. The most likely response on the part of the school districts is to end their contractual relationship with the small business men who drive the buses and look for a much larger contractor to provide the service. Thereby, you have housewives, retired people, farmers, mechanics, and other contractors. This will bear a heavy burden on their particular businesses the quality of their life.

Probably the most puzzling aspect of the IRS action in my opinion is the complete absence of any public policy goal being served here. I realize that there must be some degree of protection against the sort of unscrupulous employees who would pressure powerless employees to accept contractor status against their will, but the Maryland case is the exact opposite. The most vocal critics of the IRS action are the bus drivers themselves.

I realize that independent contractor status can, in some cases, have adverse consequences for Federal revenue collection. It is easy to recognize that there is a greater potential for tax evasion for an independent contractor than for an employee. However, in the appeals process, it became clear that tax compliance among the schoolbus contractors approachers 100 percent. A change in the status of these contractors will yield insignificant revenues to the Federal Government, but such a change will create hardships for the districts. If they are forced to treat the bus drivers as employees, they will have to create benefit packages and a full range of other issues that the boards of education will have to deal with. It will also eliminate dozens of small businesses.

Section 530 provides that procurers of contractor services who are subsequently determined to be employers can be afforded relief if certain standards are met; that they had a reasonable basis for believing the contract relationship was appropriate; that they consistently issued 1099 Forms instead of W-2 Forms; and that they

had no similar positions filled by employees.

The IRS denied section 530 relief to these school districts noting that the bus drivers for special schools were employees, and as I stated a little bit earlier, I find it somewhat astounding that the IRS fails to recognize that bus drivers for special schools are actually very different than bus drivers for regular schools. They require additional training. There are different hours of the day that you drive. There is a full range of special necessary responsibilities for special schools that you simply do not have for the regular public schools.

H.R. 1972 would solve this problem summarily, creating a new and clear parallel standard for defining contractor relationships with reasonable protections against abuse. The bill requires substantial investment in training or assets, a separate place of business, and an express contractual agreement. One can argue that this legislation would be unnecessary had the IRS been more reasonable in its pursuit of cases like the one I just described. However, the zeal with which the IRS seems to pursue these contract cases seem to have necessitated legislative action to provide protection for contractors and businesses who procure contract services.

I would, therefore, encourage two actions on the part of the Subcommittee. First of all, I would encourage the Subcommittee to use all available expediency in reporting H.R. 1972 or similar legislation to clarify the definition of a contractor, but recognizing the difficulty of passing any sort of tax legislation, I would also urge the Subcommittee to vigorously exercise its oversight of the IRS in the area of the independent contractor issue.

Once again, Madam Chairman, I appreciate the opportunity to

testify before your Subcommittee.

[The prepared statement follows:]

STATEMENT OF CONGRESSMAN WAYNE T. GILCHREST

HOUSE WAYS AND MEANS COMMITTEE

OVERSIGHT SUBCOMMITTEE

JUNE 20, 1996

Madame Chairman and members of the committee, I would like to thank you for the committee's indulgence. I know that member testimony on the independent contractor issue was supposed to be presented at your June 6 hearing on the subject, a date when I was unable to be in Washington. I appreciate the opportunity to testify today on H.R. 1972, as well as a matter which has significant ramifications for the taxpayers, school districts, and children in my district.

I am aware that the committee has already received testimony from Dr. Sam Meek, Superintendent of Talbot County Schools, and my testimony is meant primarily to add emphasis to what he said.

In Maryland, as with other states, it is a common practice for school boards to contract out their school-busing services to self-employed individuals. Nearly every school district on the Eastern Shore has operated under such an arrangement for decades, and everyone has been happy with it. Recently, however, this contractual arrangement has come under scrutiny from the Internal Revenue Service, and that agency has made the determination that under the common law test currently used to determine contractor status, these school bus drivers had to be considered employees.

This determination has been particularly disruptive for the affected counties. The IRS is currently assessing several counties for back payroll and other taxes, and the school districts are considering several options, none particularly desirable, for addressing this problem. The most likely response on the part of the school districts is to end their contractual relationship with the small businessmen who drive the buses, and look for a larger contractor to provide the service.

Probably the most puzzling aspect of the IRS' action is the complete absence of any public policy goal being served. I realize that there must be some degree of protection against the sort of unscrupulous employers who would pressure powerless employees to accept contractor status against their will. But the Maryland case is the exact opposite -- the most vocal critics of the IRS's action are the school bus drivers themselves.

I realize that independent contractor status can, in some cases, have adverse consequences for federal revenue collection -- it is easy to recognize that there is a greater potential for tax evasion for an independent contractor than with an employee. However, in the appeals process it came clear that tax compliance among the school bus contractors approaches 100%. A change in the status of these contractors will not yield significant revenues to the federal government.

But such a change will create hardships for the districts. If they are forced to treat the bus drivers as employees, they will have to create benefits packages and deal with labor laws. It will also eliminate dozens of small businesses.

Section 530 provides that procurers of contract services who are subsequently determined to be employers can be afforded relief if certain standards are met -- that they had a reasonable basis for believing the contract relationship was appropriate; that they consistently issued 1099 forms instead of W-2 forms, and that they had no similar positions filled by employees. The IRS denied 530 relief to these school districts, noting that the bus drivers for the special schools were employees. I find it astounding that the IRS fails to recognize that driving a bus for

special schools is vastly different from driving buses for the regular schools -- it requires additional training, different work rules, etc. Yet the IRS has been unyielding on this point.

H.R. 1972 would solve this problem summarily, creating a new and clear parallel standard for defining contractor relationships with reasonable protections against abuse. The bill requires substantial investment in training or assets, a separate place of business, and an express contractual agreement. One can argue that this legislation would be unnecessary had the IRS been more reasonable in its pursuit of cases like the one I just described, however, the zeal with which the IRS seems to pursue these contract cases seems to have necessitated legislative action to provide protection for contractors and businesses who procure contract services.

I would therefore encourage two actions on the part of the committee. First of all, I would encourage the committee to use all available expediency in reporting H.R. 1972 or similar legislation to clarify the definition of a contractor. But recognizing the difficulty of passing any sort of tax legislation, I would also urge the committee to vigorously exercise its oversight of the IRS in the area of independent contractor issues.

Once again, I thank the committee for this opportunity to testify.

Chairman JOHNSON. Thank you very much, Congressman Gilchrest.

We did hear from Superintendent Meek last time. I think this is an extremely important issue because it is a perfect example of the problems created by the IRS going in and reclassifying people in the face of the section 530 language that recognizes longstanding

practice. So, this is a very big problem that you point to.

Second, I think it is interesting, and I think this will be reflected in testimony that we hear later on, that among workers who filed their 1099 forms, those workers report 97 percent of the amounts as income. If the payments were not reported, the reporting average falls to 87 percent. So, the problem in this sector is not amongst those who report their 1099s from the point of view of tax compliance, and yet, for obvious reasons, the IRS' enforcement efforts have been focused at those who report their 1099s because they are visible, and that is one of the real problems that has plagued this compliance effort and one that I think the Commissioner is keenly aware of and that we are keenly aware of.

I am very interested in our work having an impact on your school district because school districts all over the country will be affected if we make a change in this area, and yet, it would have essentially no impact on the amount of tax revenue that the public

gets. As you say, there is no public interest.

So, we appreciate your supporting your superintendent and drawing out very clearly for us the nature of the problem, and we are interested in assuring that our actions will solve it.

Mr. Kleczka.

Mr. KLECZKA. Thank you, Madam Chairman.

I am not very familiar with the Maryland School Board situation. Mr. Gilchrest, are you saying that the school district has two types of bus drivers, the contract type and also an employee type, which is responsible for the special education kids?

Mr. GILCHREST. This will vary, but for the most part, the employees of the school will carry children who are disabled, those who are in wheelchairs, those who have severe mental deficiencies.

Mr. KLECZKA. So, those bus drivers are employees?

Mr. GILCHREST. Of the school district.

Mr. KLECZKA. The bus drivers who transport the other population are contract?

Mr. GILCHREST. For the most part, those are individuals that contract with the school district for a particular area to pick up kids to take them to the different schools.

Mr. KLECZKA. Who owns the schoolbuses?

Mr. GILCHREST. The schoolbuses are owned by the contractors.

Mr. KLECZKA. So, I as an individual, if I want to drive for your school district, I would have to bring my own bus along. Is that how that works?

Mr. GILCHREST. For the most part, yes. There are some people, contractors, that might own three, four, or five buses, and he would hire people to drive those buses. There are others, though, who simply own their own schoolbus.

Mr. KLECZKA. For the individual who owns three or four buses, is he also an independent contractor and all of his drivers? At what point does he become a small business person himself or herself?

Mr. GILCHREST. He is an independent contractor, and then, basically, he would hire people to drive his buses, but he would contract with the school district for that particular area where they

would pick up for that particular bus run.

For the most part, with very little variations, the board of education will contract with someone to pick up certain students along certain bus runs. There might be four bus runs with four buses and one contractor, and then that contractor would contract for those four bus runs and he would hire people to drive on his buses.

Mr. KLECZKA. In a situation where the person owns four or five buses, probably drives one him- or herself, are the other three or

four drivers employees of that small business?

Mr. GILCHREST. I do not know every single situation.

Mr. KLECZKA. OK.

Mr. GILCHREST. Of the situations that I know, the person that might own four buses, the people that drive his buses will be

employees.

I will give you an example. There is a man named Mr. Dorsey in Kent County who owns buses. He will hire people to drive those buses. Mr. Dorsey is the independent contractor that contracts with the school district, but the drivers of those buses, one of whom is his wife, will be employees of Dorsey buses.

Mr. KLECZKA. So, the argument here, or the problem here, is that the owner of the buses is not calling his drivers independent

contractors, also?

Mr. GILCHREST. Say that again?

Mr. KLECZKA. So, the question or the problem in Maryland is not that the owner of multiple buses does not call his drivers or her drivers independent contractors. He does term them employees.

Mr. GILCHREST. That is correct.

Mr. KLECZKA. So, that is not the problem.

Let me ask IRS if they have any more information on this so I can get a better understanding.

Thank you very much.

Mr. GILCHREST. Thank you.

Chairman JOHNSON. Mr. Hancock.

Mr. HANCOCK. Just as a matter of curiosity, what would happen in your opinion, or are there any cases where the school contracts with a cab service to pick up kids where they do not have enough to justify a bus?

Mr. GILCHREST. Cab service?

Mr. HANCOCK. Yes.

Mr. GILCHREST. Do you mean in an automobile?

Mr. HANCOCK. Sure.

Mr. GILCHREST. I do not know of any situation.

Mr. HANCOCK. Well, I know, but it does happen in certain areas where they have got one person or two and they do not want to send a bus out there, and they arrange to pay for cab service to pick up that one child.

Mr. GILCHREST. What would happen if you had to arrange for a

cab?

Mr. HANCOCK. Would that make the cab driver an employee?

Mr. GILCHREST. An employee of the school district.

Mr. HANCOCK. Yes.

Mr. GILCHREST. That is a good question, Mel. I am not sure how that would work, but I am sure there might be some areas of the country where that happens.

Mr. HANCOCK. Oh, it does happen.

Thank you.

Chairman JOHNSON. Mr. Laughlin.

Mr. LAUGHLIN. Mr. Gilchrest, as I understood your statement about Mr. Dorsey and his operation, all of the drivers to your knowledge are his employees.

Mr. GILCHREST. Yes.

Mr. LAUGHLIN. It occurs to me that even the bus driver, or Mr.

Dorsey could be an independent contractor.

Mr. GILCHREST. I think that is probably likely, but the people in the incident where you have Dorsey Bus Service, where he contracts with the school district to drive students to the public schools, the people he hires are employees of Mr. Dorsey's.

Now, there are not too many contractors that own several buses. The vast majority of the contractors on the Eastern Shore are individuals that own their own buses, and they have an individual contract with the school district.

Mr. LAUGHLIN. You are primarily concerned with the relationship

between the bus operator and the school district.

Mr. GILCHREST. That is my primary concern. My judgment is if the IRS continues to pursue this policy, we will virtually have no independent contractors. They will contract out to basically the lowest bidder, and you will probably get some type of national bus service in there. Those people who are independent businessmen will become either unemployed or their independent status will be greater diminished by simply becoming employees of a very large bus contractor.

Mr. LAUGHLIN. Do you have the information of how many other States have a similar situation to Maryland or the Eastern Shore of Maryland where the school district contracts with private bus operators? In my State, to my knowledge, the school district owns all the buses. There may be a private contractor, but I am not familiar with it. I do know there are a couple of other States where they have a private contractor. Do you have that information?

Mr. GILCHREST. No, I do not have that information. I know it will vary from around the country. I do know States like Delaware, many of the Mid-Atlantic States, and I am sure many other rural areas of the country have an independent contractor status, and my fear is that the ramifications of this to many States and school districts around the country that have the independent contractor status is that it is going to change.

I believe that Maryland is one of the first places they have tar-

geted to change this independent contractor status.

Mr. LAUGHLIN. The last question I have, from your vantage point, living on the Eastern Shore around these school districts, is the school children transportation system broken to the point where it needs to be fixed by the IRS?

Mr. GILCHREST. I would say the school transportation system in

my judgment is working extremely well.

Of my three children, my two boys who are out of school now, rode on those buses. My daughter is now riding on these buses.

The bus drivers are people that live in the community. They know the children. They are fine. I do not mean to sound too corny on this, but some of those bus drivers have set some very positive role model examples for those kids because they are neighbors, and they are actually a part of our extended family.

Mr. LAUGHLIN. So, the system is not broken. Mr. GILCHREST. The system is not broken.

Mr. LAUGHLIN. Thank you, Mr. Gilchrest.

Mr. GILCHREST. Thank you.

Chairman JOHNSON. Thank you, Congressman Gilchrest.

Mr. GILCHREST. Thank you, Madam Chairman.

Chairman JOHNSON. Now I would like to call Don Lubick, the Acting Assistant Secretary for Tax Policy, Department of Treasury. Welcome.

STATEMENT OF DONALD C. LUBICK, ACTING ASSISTANT SECRETARY FOR TAX POLICY, U.S. DEPARTMENT OF THE TREASURY

Mr. LUBICK. Thank you, Madam Chairman and Members of the Subcommittee. It is a pleasure to be back here, and I am very pleased that my first visit here is talking about the same thing I was talking about when I went up to——

Chairman Johnson. Excuse me, Mr. Lubick. As you start, I

didn't realize, but I meant to call you both at the same time.

Peggy Richardson, Commissioner of the Internal Revenue Service. Welcome, Commissioner Richardson.

Ms. RICHARDSON. Thank you.

Chairman JOHNSON. Mr. Lubick, if you will proceed.

Mr. LUBICK. I was saying I am talking about the same issue I

was talking about when I left in 1980.

I would like, if you please, to have my written statement submitted for the record and then talk informally, if I may, about the subject.

Chairman JOHNSON. Certainly.

Mr. Lubick. As you have stated, this has been a very contentious issue for a long number of years, the question of classification of workers for various purposes. I have been involved in it not only in my governmental role, but had extensive experience with it in private practice of law, representing people who were contending for independent contractor status and representing people that were contending that other people should be given employee status. So, I think I have been on every side of this question of representing employers, workers, and the government.

I would like to give by way of background some general principles that I think we ought to keep in mind as we search for a solution which I hope is not the quest for the impossible dream.

In almost all areas, the laws necessarily—if they are dealing with questions involving service providers—tend to separate workers into two baskets, and for convenience, historically, one kind of treatment is given to workers who are denominated as employees and to others who are denominated as independent contractors.

It has been pointed out that taxation is not the only area where this difficult distinction has to be drawn. It is significant under a variety of worker protection laws, such as, laws that provide worker's compensation to protect workers from injuries on the job, fair labor standards to deal with other protections for workers, and unemployment insurance to deal with those who are entitled to protection in the event they become unemployed.

The State laws as well as the Federal laws seem to use general terminology classifying employees on the one hand as the object of either protection or some requirement, such as, withholding in the

tax law, and independent workers on the other hand.

I suppose it is possible to come up with other terms to get away from the term "employee" and "independent contractor," but I would suspect that if we used that other terminology, we are not going to produce any greater precision or any greater clarity than the familiar one that we have been using of "employee" versus "independent contractor."

The problem is that there are numerous kinds of arrangements for the provision of services that run a wide spectrum, and as we progress, we are finding there is more and more ingenuity and more and more variety in these arrangements, but the law must separate service providers into the basic two categories, those that are covered by the object of the law and those that are not.

Most workers, it would seem, fit clearly into one category or the other because of the characteristics of their work arrangements. There are a number of people whom we would clearly classify as employees, a number whom we would clearly classify as independ-

ent businessmen.

Inevitably, when you have two sets to deal with, there is a middle range of arrangements that share simultaneously some of the principal characteristics that are reflected in the independent contractor and in the employee status. So, it is not clear to which cat-

egory they should be assigned.

One of the problems is that the tax law very often, too frequently I would say, drives businesses, workers, and government administrators to try to push the hybrid arrangements on one side or another. What we are concerned about is that the tax law determination may have consequences, often not the intended consequences, in many other areas, as Mr. Kleczka has pointed out, even though lip service is paid to the independence under each law of the definitional classification.

The fact is that historical practice, the use of common terminology, the similarity of the criteria to cast the worker on one side or another, all tend to point to similar outcomes. So, the tax decisions concerning classification will have an effect beyond either securing

or undermining tax compliance.

The fact of the matter is that after looking at this question for over 25 years, we have found that we have inherently factual questions, an infinite variety of situations, and we have found that rules of classification are very difficult to verbalize in mechanical terms. Determining the nature of an employment relationship is similar to other legal concepts that you are familiar with, such as negligence. How do you tell what is or isn't negligence by setting forth a pattern of words that will apply in all cases?

Justice Stewart made a famous quotation about pornography—I know it when I see it, even though I cannot articulate how to define it. I think we have a situation here where there are general

principles that all of us would agree on. First of all, that the government should not be interfering with or dictating the legal form of a service relationship between the provider and the recipient except if it is truly necessary to protect an important government policy, whether that be tax compliance, unemployment protection, protection relating to job-related injuries, or the like.

I think there is another factor that everybody would agree on, that simply calling a worker an independent contractor by applying a label that the parties agree on, is not enough to justify a different treatment from a worker in an identical factual situation who receives unemployment protection, realizes tax compliance, and so on. Economic reality should override attempts by any individuals to opt out of a system simply by mislabeling.

So, that gets us down to how do we solve this particular situation, how do we prevent what I believe most persons want to prevent—inducing through the tax law a significant shift from employee status that would affect not only taxation, but other areas.

We have been searching for comprehensibility and certainty, and we have come to the conclusion that it is not likely attainable by verbal formulae. Our preference would be for consistency of classification in all areas if that is feasible and comparable treatment of workers in comparable conomic relationships

workers in comparable economic relationships.

So, we have been searching in this area, and we have seen many bills introduced either for safe harbors or definitions that will solve the problem. In designing a safe harbor, if we have a safe harbor that covers too few workers, we haven't done anything, because all we are doing is giving safe harbor treatment in the obvious cases. If the safe harbor is too broad, it is going to undercut those legal protections that we want to afford workers, the government, or the

employer in its area of application.

The same thing is true of definitions. You have alluded to the socalled 20 factors, and I will have something to say about that in a bit, but basically, as we have studied the offerings of factors that are supposedly conclusive, we have found that generally, the attempt to define them provides simply a road map to avoidance because individuals who want to classify in one direction or another are able to manipulate the definitions to throw the classification on one side or another. In effect, the use of definitive factors, for the most part, seems to shift the fight over uncertainty simply to a different terrain. If definitional factors are applied in a very mechanical way, they are easily manipulable.

We have come to the conclusion, therefore, that the time has come to see if there isn't another way to solve the problem. Instead of this quest for a verbal formula to put workers and independent contractors on one side, isn't there a way to defuse the conflict, to defuse the contentiousness of the issue? I have two suggestions to offer today. One is to shift the focus to simple and expeditious methods to resolve conflicts between businesses or workers and the government, and the second is to lower the stakes that are involved

in this situation.

We would defuse the controversies by making them less than life-and-death issues. We have been presented with cases, and I have seen them myself, where the Service comes in to audit an employer, claims back taxes for several years, and the taxes are not based on income which went into the balance sheet or the pockets of the employer. It is payroll. It is expenses paid. Of course, there may be a right to get the money out of the workers, but that is not very practical. They cannot be found, and who knows what they have done with the money.

So, the result is that in many situations, and this is what came up in the early days, we found that businesses were facing, in the event the audit position of the Service was accepted, bankruptcy

and liquidation. So, we have to do something about that.

Second, I think we ought to be alert to the fact that a number of provisions of the tax law will induce shifting one way or another. For example, the 2 percent limitation on deduction of business expenses by employees is a real incentive to classify a person as an independent contractor, and there may not be a rational distinction for that rule.

I recognize that many of these rules cannot be changed because of revenue constraints, but I would urge that the Committee be alert in its actions in the tax law to see if it is possible to avoid making distinctions that sharpen the tax advantages where there

perhaps is not so much justification.

In dealing with the ways to resolve the controversies, we would like to suggest two things. We would suggest the possibility of liberalizing by legislation the use of prospective reclassification in cases of reasonable error. Too often the situation has been if the Service's position is sustained, there is no way to avoid the onerous imposition of assessments that we have talked about on the business that will make its financial survival impossible.

In many cases that I have been involved in personally, if a way could be found to resolve the matter on a going-forward basis, the employer who had made a reasonable misclassification could survive and adjust practices. The Service has been moving in this direction, and the Commissioner has referred in her testimony to a settlement procedure that mitigates the impositions considerably.

I would suggest that the Committee consider legislation to go even further and to permit the Service, where the taxpayer had a reasonable argument and belief that it was entitled to section 530

protection, to allow complete prospectivity of classification.

One of the problems with the settlement procedure is that it may put the taxpayer under a shotgun situation. He may feel that he has a reasonable chance of winning a section 530 case, and yet, he is afraid to turn down a settlement offer even on a prospective basis because if he goes to court, he stands a chance of losing and then it is too late.

Therefore, we would suggest that legislation offer a new remedy to the taxpayer under audit. The taxpayer may think he is right, but cannot afford to settle. So, we would give this latitude to the Tax Court. We would enlarge jurisdiction of the Tax Court to allow an expeditious appeal from a determination by the Revenue Service. Much in the way that we allow determination of the qualified status of pension plans or the qualified status of exempt organizations, we would allow the Tax Court to decide under expeditious procedures the worker classification, and we would give the Court the same authority that we would give the Service in the event the Court finds against the taxpayer, but finds that the tax-

payer had a reasonable basis, had treated the workers consistently in all cases, had been filing information reports. In that case, we would allow the Court as a part of its decision to say yes, going forward, this rule is adverse to the taxpayer, but we will apply it

only on a prospective basis.

The Tax Court has at the present time in small business cases procedures that make litigation expeditious and inexpensive. Rules of evidence are modified. We believe that if there is increased access to an independent body that taxpayers would feel much more comfortable. We believe that at the Internal Revenue Service as well, knowing that an independent body could ultimately make a decision, there would be a much greater disposition on both sides to reach a compromise and a reasonable settlement.

In addition to that, we

Chairman JOHNSON. Mr. Lubick, if you could kind of summarize and move along.

Mr. LUBICK. All right.

Chairman JOHNSON. I think we need time to discuss some of these things.

Mr. LUBICK. I would like to just simply state one or two other items that I would suggest in this area that are administrative.

We think that flat safe harbors, that flat definitions give false illusions and will lead to unmanageable standards and litigation. The Commissioner's testimony will describe some proposed administrative guidance to mitigate actual or perceived problems with section 530.

Finally, we would suggest that if the Congress would permit us to give guidance that we could basically withdraw the 20-factors test and work to disabuse taxpayers of the notion that they have to parse literally the 20 factors that are in the Revenue ruling, and instead, we think working with the Service in this area we could clarify the factors to be used in deciding classification as well as the weight to be given them.

The 20 factors were never intended to do the job that they have been asked to perform, and if we are permitted to give guidance, I think we would follow a notice procedure on which the public and the Congress could comment and provide input, and I think we can

do much better than the existing situation.

Basically, Madam Chairman, I think that there are always going to be some hard cases, but if we can reduce the stakes, if greater guidance and assistance allow only prospective review and provide a new jurisdiction that is independent of both the taxpayer and the Revenue Service that we can make very substantial progress in this area.

[The prepared statement follows:]

STATEMENT OF
DONALD C. LUBICK
ACTING ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE

SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES

Madam Chairman and Members of the Subcommittee:

I am pleased to be here today to present the views of the Department of the Treasury on issues relating to the classification of workers as employees or independent contractors. This is a significant and complex issue that merits careful study. We commend the Members of this Subcommittee for holding hearings on this important subject.

Background

Whether workers are classified as employees or as independent contractors is significant for both Federal income tax purposes and Federal employment tax (i.e., Social Security, Medicare, Federal unemployment insurance and withholding) purposes. Income, Social Security and Medicare taxes on employees are collected mainly by employers through the withholding system, whereas the same taxes on independent contractors are collected mainly through self-assessment under the estimated tax system. Independent contractors can offset income by deductions for business expenses that generally are not as readily available to employees (except to the extent that the employee itemizes deductions and business expenses and other miscellaneous itemized deductions exceed 2 percent of adjusted gross income). In contrast, certain fringe benefits provided by a business to employees are eligible for greater tax preferences than are available to independent contractors, although independent contractors can adopt tax-qualified self-employed retirement plans that can be similar to employer-sponsored plans for employees. The classification of workers as employees or independent contractors is also significant under a variety of Federal and State labor and worker protection laws that cover only employees, such as unemployment insurance, workers' compensation, wage and hour requirements, and family and medical leave requirements.

Most workers are classified as employees or independent contractors based on the traditional common-law test for determining the employer-employee relationship. This test

¹The Internal Revenue Code (Code) does contain special rules for classifying certain categories of workers. Briefly, these include mandatory independent contractor classification of certain licensed real estate agents, direct sellers, and sitting-service placement agents (sections 3506 and 3508 of the Code); and mandatory employee classification of corporate officers and

focuses on whether the employer has the right to control not only the result of the worker's services but also the means by which the worker accomplishes that result.

The common-law control test is, by its nature, a test that depends on the specific facts and circumstances of each situation. In an effort to administer this facts and circumstances standard better, the Internal Revenue Service (IRS) has derived from the case law a variety of factors that should be considered, with more or less weight being accorded to particular factors depending on the factual context. In the vast majority of cases, the classification of a worker under the common-law standard is clear. However, because the control test is inherently a factual determination, there are cases in which the correct status of a worker is less obvious. The uncertainty in these cases has been perpetuated by the long-standing statutory prohibition on the issuance of regulations or revenue rulings regarding the proper classification of workers.

Current tax law does not consistently favor status as either an employee or an independent contractor. However, in particular circumstances one of the classifications may be advantageous to a service provider, the service recipient, or both. A company's costs may, for example, be lower if its workers are classified as independent contractors rather than employees to the extent the company can pay independent contractors less than the sum of the cash compensation, the costs of the company's portion of Social Security and Medicare taxes, unemployment insurance, workers' compensation, other fringe benefits that the company incurs for employees, and the overhead costs of withholding and recordkeeping. In addition, the income and employment tax provisions of the Code may favor classification as an independent contractor where a worker has significant unreimbursed business expenses. This is primarily because independent contractors face significantly fewer restrictions on their ability to deduct trade or business Conversely, employee expenses than employees, as noted earlier.4 status may be advantageous for workers with few business expenses

certain agent-or commission-drivers, life insurance salesmen, home workers, and traveling salesmen (section 3121(d) of the Code).

²Cases in which there is intentional misclassification of an employee as an independent contractor should be distinguished from the classification issue generally. In these cases, there is no real question as to whether the workers are employees or independent contractors. Rather, the parties involved may use misclassification as a guise to avoid the costs of Federal and State mandates designed to protect employees or as a method to avoid full reporting of income and to evade taxes.

³Prior to 1984, compensation earned by independent contractors was subject to lower rates for Social Security and Medicare taxes than wage income. This disparity was believed to create an incentive for misclassification. The differences were actually less significant than they appeared, however. Although tax rates were lower for self-employment income than for wages, an independent contractor could not deduct self-employment taxes while an employer could deduct its portion of Social Security and Medicare taxes in computing its taxable income for income tax numbers.

'Also, the estimated tax system used to collect income, Social Security, and Medicare taxes from independent contractors largely avoids the overwithholding that can result when an employee incurs large business expenses, has net income that fluctuates during the year, or is employed for only part of a year.

who benefit from the tax advantages accorded to fringe benefits, especially those that are more cheaply obtainable or only obtainable through an employer, such as employer-provided group health insurance, workers' compensation insurance, or unemployment insurance.

Workers who are classified as independent contractors may also have greater opportunities than employees to avoid full compliance with the tax laws. As previously noted, employees are subject to withholding, and the amount of their wage income is reported with great precision to the IRS. Independent contractors may find it easier to omit some of their income on their tax returns without detection. Underreporting of income becomes more difficult when an independent contractor's gross income is reported to the IRS on information returns, although the worker can incorporate and avoid information reporting because of the current law rule which excludes payments to corporate independent contractors from reporting. Moreover, even independent contractors that report 100 percent of income have greater opportunities to overstate deductible business expenses. Clearly, some taxpayers have made use of these opportunities, and this has resulted in significant amounts of noncompliance.

Recent Legislative History

Since the late 1970s, Congress, Treasury, and the Internal Revenue Service have considered numerous proposals aimed at resolving issues associated with the classification of workers as employees or independent contractors. To date, legislation dealing with classification issues has focused primarily on relieving employers of what has been viewed as the excessive penalties associated with honest errors in the misclassification of employees as independent contractors.

Prior to statutory changes, when the IRS reclassified a worker as an employee, the employer was generally held liable for the full amount of unwithheld income taxes and the unwithheld employee share of Social Security and Medicare taxes for all years open under the statute of limitations. In addition, the employer remained liable for the employer share of Social Security, Medicare and Federal unemployment insurance taxes, plus interest on these amounts. Penalties also could be assessed. The employer's liability for underwithholding was abated to the extent that the employer could demonstrate that the misclassified worker had paid income, Social Security and Medicare taxes on the compensation received. Data to support the determinations were often difficult to obtain, however, especially if the worker was no longer providing services to the employer.

Section 530. In response to a number of large retroactive employment tax assessments in the 1970s, Congress provided certain employers with general statutory relief from IRS reclassification of workers from independent contractors to employees. Section 530 of the Revenue Act of 1978 prohibits the IRS from correcting erroneous classifications of workers as independent contractors for employment tax purposes, including prospective corrections, as long as the employer has a reasonable basis for its treatment of the workers as independent contractors. A reasonable basis includes reliance on (i) judicial precedent, published rulings, letter rulings or technical advice memoranda; (ii) a past IRS audit (although not necessarily an employment tax audit) in which there was no assessment attributable to the employment tax treatment of the worker or of workers holding substantially similar positions; (iii) a long-standing recognized practice of a significant segment of the industry in which the worker was engaged; or (iv) any other reasonable basis for the employer's treatment of the worker.

The relief provided by section 530 is not available unless the employer consistently treats the worker, and any other worker holding a substantially similar position, as an independent contractor (sometimes referred to as the "substantive consistency" test) and complies with the statutory requirements for payments to independent contractors. For example, section 530 relief is not available if the employer has failed to comply with the information reporting requirements associated with its treatment of the worker as an independent contractor.

Section 530 applies solely for purposes of the employment tax provisions of the Code. It has no legal effect on an employer's treatment of a worker as an employee for income tax purposes. Further, it does not affect the worker's own tax treatment for any purpose. Consequently, section 530 can result in the receipt of less than the appropriate amount of employment taxes for some workers. This is because these workers are simultaneously treated as employees for their own tax purposes, and thus are subject only to the employee share of Social Security and Medicare taxes, and are treated as independent contractors by their employers, which pay no employment taxes with respect to these workers. As a result, an amount equal to the employer portion of Social Security and Medicare taxes is not paid. Section 530 also has no impact on determinations of employment status for other purposes, such as eligibility for workers' compensation and unemployment insurance.

Section 530 was enacted as a one-year "stopgap" measure until Congress could devise a less contentious standard for classifying workers. It was extended several times and finally extended indefinitely in 1982.

Section 530 prohibits the IRS from issuing any regulations or revenue rulings regarding the proper classification of workers. As a result, the IRS has not been able to issue any generally applicable guidance in this area for close to 20 years.

Section 3509. In the Tax Equity and Fiscal Responsibility Act of 1982, Congress added section 3509 to the Code in order to mitigate employers' liabilities for retroactive employment tax assessments where section 530 relief was not available. Section 3509 generally limits an employer's liability for failure to withhold income, Social Security, and Medicare taxes on payments made to an employee whom it has misclassified as an independent contractor.

Under section 3509, an employer is liable for 1.5 percent of the wages paid to the employee, in lieu of the income taxes that were not withheld, plus 20 percent of the employee's portion of the Social Security and Medicare taxes on those wages. If the employer has not complied with the information reporting requirements associated with the treatment of the worker as an independent contractor, however, these percentages are doubled to 3.0 and 40 percent, respectively. In addition, the employer's liability under section 3509 cannot be reduced by any self-employment or income taxes paid by the misclassified worker. Section 3509 also does not relieve the employer of its liability for 100 percent of the employer portion of Social Security and Medicare taxes. The relief provided by section 3509 is not available if the employer has intentionally disregarded the withholding requirements with respect to the employee.

The rules of section 3509 were developed in an attempt to place employers and the Federal Government in approximately the same financial position, on average, in which they would have been if the amount of taxes actually paid by the misclassified employees had been determined and used to abate the employers' liabilities, without the need actually to determine those amounts. Thus, section 3509 has no effect on an employer's own liability for Federal or State unemployment insurance taxes or

the employer portion of Social Security or Medicare taxes. Also, in return for limiting the employer's liability for failure to withhold employee taxes, section 3509 prohibits the employer from reducing its own liability by recovering any tax determined under the section from the employee, and, as discussed above, gives it no credit for any taxes ultimately paid by the employee.

Section 1706. In the mid-1980s, some employers in the technical services industry complained that the relief granted under section 530 created an unfair advantage for certain of their competitors. They noted that section 530 affects different taxpayers differently, depending on whether they satisfy the statutory conditions for relief. In particular, employers that have consistently misclassified their employees as independent contractors are entitled to relief under section 530, while other employers in the same industry (that, for example, have sometimes taken more conservative positions on classification issues) are not entitled to relief because they cannot satisfy the consistency requirements of section 530. The crux of the employers' complaints was that certain taxpayers in the industry achieved unfair cost savings by treating the service providers as independent contractors.

As a result of these complaints, in section 1706 of the Tax Reform Act of 1986, Congress excluded from the ambit of section 530 taxpayers that broker the services of engineers, designers, drafters, computer programmers, systems analysts and "other similarly skilled workers engaged in a similar line of work," effective for payments made after December 31, 1986. Section 1706 applies exclusively to multi-party situations, i.e., those involving (i) technical services workers, (ii) a business that uses the workers, and (iii) a firm that supplies the workers to the business. The effect of section 1706 is to deny section 530 relief solely to the firm that supplies the workers. Section 1706 did not affect the application of section 3509 to such firms.

Recent Administrative Initiatives

The IRS has recently announced several administrative initiatives to improve the current situation in the worker classification area.

In March of this year, the IRS released to the public for advance comment new training materials for IRS examiners. The training materials are intended to ensure that examiners make legally correct determinations about whether workers are properly classified as employees or independent contractors under the

⁵Under section 3509, as under prior law, the full amount of the misclassified worker's gross compensation is subject to tax, even though, if the worker had always been treated as an employee, the employer would presumably have negotiated to reduce wages to reflect the employer's liability for its portion of Social Security and Medicare taxes, unemployment insurance, and any fringe benefits provided by the employer at its option.

⁶As explained above, however, misclassification of an employee as an independent contractor does not necessarily result in any cost savings. However, cost savings could be achieved if, for example, the client is able to pay the independent contractor less than the sum of the cash compensation, its portion of Social Security and Medicare taxes, unemployment insurance, workers compensation, the cost of other State and Federal protections, fringe benefits that it would have paid to an employee, and the overhead costs of withholding and recordkeeping. Cost savings also could be achieved if the worker accepts a lower payment as an independent contractor because he intends to evade taxes by underreporting income or overstating deductions.

common-law standard. The materials emphasize to examiners that they must approach the issue of worker classification in a fair and impartial manner, and remind examiners that either worker classification — independent contractor or employee — can be a valid and appropriate business choice. These new training materials also demonstrate how the application of the common-law standard has evolved to reflect the changing nature of business relationships. The materials (including the opportunity provided for taxpayers and all other interested parties to comment on a draft of the materials) and the IRS training program based on the new materials will help promote both consistency and additional clarity concerning IRS application of the common-law classification standard.

The IRS training document also addresses in detail the application of section 530 of the Revenue Act of 1978. It makes clear to examiners that section 530 should be actively considered during an examination. In fact, the materials state that examiners are required to explore the applicability of section 530 even if not raised by the taxpayer, in order to correctly determine the taxpayer's tax liability.

Another recent initiative taken by the IRS is a classification settlement program that allows businesses to resolve worker classification cases earlier in the examination process, reduce taxpayer costs, and ensure the proper application of the provisions of section 530. Businesses that have misclassified their workers as independent contractors, have filed Form 1099 information returns, but have failed to meet all of the other requirements for relief under section 530, can settle the matter with IRS examiners by reclassifying their workers prospectively and paying only limited tax assessments. This reduces the risk that tax assessments could be applied for multiple years.

Participation by businesses in the settlement program is entirely voluntary, and businesses declining to participate retain all rights that exist under the IRS's current procedures. The program is intended to simulate the results that would be obtained under current law if businesses accepting the offers had instead exercised their right to administrative or judicial appeal.

In addition, the IRS has recently announced procedures for allowing businesses, at their option, to resolve employment tax issues more quickly by appealing these issues to the IRS Appeals function even while an examination on other issues is still in progress. The appeals procedure runs for a one-year test period during which time it will be evaluated.

Further, we are working with IRS to develop administrative guidance on the often difficult issue of whether a taxpayer has satisfied section 530 by virtue of reliance on a long-standing

⁷The program is scheduled for a two-year test period during which time it will be evaluated.

^{*}If the business meets the section 530 reporting consistency requirement but the business either clearly does not meet the section 530 substantive consistency requirement or clearly cannot meet the section 530 reasonable basis test, the assessment would be limited to one year of employment tax liability (as limited by Code section 3509). If the reporting consistency requirement is met and the business has a colorable argument that it meets the substantive consistency requirement and the reasonable basis test, the assessment would be limited to 25 percent of one year's income tax withholding, Social Security and Medicare tax liability for the year (as limited by Code section 3509), plus the Federal unemployment insurance tax liability for the year.

recognized practice of a significant segment of the industry in which the worker was engaged. The guidance is expected to provide that, in defining a significant segment of an industry, no fixed percentage is appropriate for all cases because the determination is part of a facts and circumstances analysis involving a number of variables. However, depending on the facts, less than a half of the industry may constitute a significant segment of the industry. In addition, the guidance is expected to make clear that, while determination of whether a practice is "long-standing" is based on facts and circumstances, a practice will be presumed to be "long-standing" if it has been in effect for 10 years or more, and that an industry with a "long-standing" practice can include an industry that was established after 1978 (when section 530 was enacted).

We believe that these initiatives represent a significant response to concerns expressed by taxpayers, particularly small businesses, in the worker classification area. We would urge that these initiatives be given a chance to work, especially in conjunction with the legislative changes proposed on page 10 below to eliminate past employment tax liability in certain cases where taxpayers have a reasonable argument that they meet the requirements of section 530, and to provide easier access to an independent determination by the Tax Court.

Legislative Proposals

Concerns Regarding Proposed Changes to Classification Standards. The Subcommittee will be examining legislative proposals to change the Federal tax rules for determining whether a worker is an employee or an independent contractor. In particular, the Subcommittee has requested comments on H.R. 1972 and H.R. 582. These bills would provide new standards under which workers would be classified as independent contractors. Under these bills, where the standards were not met, the current common-law classification test would still apply.

At the outset, we note that worker classification is a difficult and long-standing issue that has far-reaching implications. Fundamental issues, including issues beyond the collection of income and employment taxes, may be affected by legislative changes altering the standard for determining whether a worker is an employee or an independent contractor.

Accordingly, in evaluating possible legislative proposals in this area, we believe it is helpful to bear in mind a number of important (albeit sometimes conflicting) principles and objectives. Among these is the principle that absent good cause, government generally should not interfere in the legal relationship between workers and service recipients. At the same time, legislative changes should not impair the ability of government to collect the proper amount of income and employment taxes in a reasonable and efficient manner. In addition, an effective system of government should attempt to promote certainty and fairness in the application of the law. Consistency of worker classification for various Federal and state law purposes, and for businesses entering into similar relationships with workers, are also important considerations, in part because consistency reduces compliance burdens for businesses. Further, much of the existing legal system that is in place to protect workers against certain types of risks applies only to workers who are classified as employees. For that reason, it is important that any legislation altering the status of workers be analyzed carefully to determine its potential impact on worker protections.

Under current law, worker classification in the Internal Revenue Code directly affects income, Social Security and Medicare taxes. However, it also affects other issues such as the availability of employer-provided pensions and group health

insurance. For example, under current law, tax-qualified retirement plans sponsored by a business are permitted to cover only the business's employees. Legislation that resulted in the conversion of employees into independent contractors for Federal tax purposes would reduce the number of people eligible to save for retirement in tax-qualified employer-provided pension, 401(k), and other retirement plans. These reclassified workers would be free to establish their own tax-favored retirement plans. However, with automatic employer contributions, employee savings through payroll deduction, employer matching contributions, employer education programs, and economies of scale, employer-sponsored plans have proven to be a particularly effective means of promoting retirement savings for workers, especially for middle- and lower-income workers who might be less likely to save outside the workplace. In addition, converting employees into independent contractors could result in fewer people receiving the benefits of lower-cost group health coverage through their employers.

In evaluating any proposed legislation, it is also important to consider whether a new statutory standard under Federal tax law would lead to similar changes in coverage under other Federal and State laws, such as the laws that provide unemployment insurance, workers' compensation, minimum wage and maximum hour protections, workplace health and safety standards, and family and medical leave protections to workers who are classified as employees. This might occur, for example, if businesses that reclassified workers as independent contractors under a new Federal employment tax standard also treated those workers as independent contractors for purposes of other laws that are based on employee status. Broader reclassification under these other statutory provisions could also result from subsequent efforts, in the interest of simplification, to eliminate inconsistencies between the classification standards under those State and Federal non-tax laws and a new Federal employment tax classification standard by conforming them to the new standard. These potentially sweeping implications should be explored carefully and thoroughly before enactment of any new statutory classification standard for Federal tax purposes.

As a general matter, experience suggests that it is difficult to devise one simple, specific statutory definition or safe harbor that applies appropriately to the many varied existing worker relationships and occupations. Moreover, specific statutory rules, by contrast to regulations and rulings, are not easily adapted to the changes that are constantly taking place in an area as complex and dynamic as the American work place.

Legislative proposals to replace current worker classification rules with new standards raise a number of serious concerns. First, in an effort to achieve simplicity and objectivity in this area, some proposals would prescribe "safe harbor" criteria for classification as an independent contractor that are easily satisfied and that could result in large-scale shifting of workers from employee to independent contractor status. For example, requirements that workers have significant training in order to constitute independent contractors could be automatically satisfied by large classes of workers with licenses, professional degrees, vocational training, or various types of technical training. Requirements that workers have made themselves available to work for others could be satisfied through low-cost advertisement or registration by employees who have no intention of working for anyone other than their employers.

Second, under some proposals, worker status is easily recharacterized without altering the underlying relationship between the worker and the employer. For example, it is not difficult for an employer to structure an artificial arrangement

that would appear to meet a requirement that an individual be able to realize a profit or loss to be considered an independent contractor. An employer could require the employee to purchase or rent certain tools and supplies used in generating the employer's product, but could protect the employee from loss by directly compensating the employee through a commensurate pay increase. This could permit an employee to appear to "realize a profit or loss" without changing the nature of the employeremployee relationship or the tasks that the employee would undertake, particularly if the worker purchases supplies and rents equipment from which the worker could "walk away" if employment terminates. By similar means, an employer can fairly easily restructure payments to make it appear that an employee will incur significant unreimbursed expenses. The employer can require the worker to furnish certain tools and supplies while the employer provides a corresponding increase in the payments made to the worker that is not characterized as a reimbursement. The requirement that the worker and service recipient enter into a written agreement concerning worker classification also would fail to prevent inappropriate recharacterization of employee status, particularly where workers do not have as much bargaining power as the business.

Third, in the interest of simplification, some legislative proposals sacrifice clarity, using terms that sound easy to apply in the abstract but would leave serious ambiguities regarding their interpretation. For example, proposals may require that a worker make "significant" investment in tools, equipment, or training to constitute an independent contractor. Yet what is "significant" is not objectively determinable, and may vary among occupations and industries. Such provisions would only replace the current standards with new standards that also have inherent ambiguities.

Fourth, by permitting workers to become independent contractors by meeting alternative criteria, many proposals would allow taxpayers to apply criteria that, while appropriate in certain contexts, are inappropriate for the occupation or industry being considered. Thus, the problems identified above are exacerbated when one or two criteria alone become determinative in classifying workers. In a well-meaning attempt to craft a "one-size fits all" solution, legislators may craft a standard that is too loose for many occupations and industries. For example, some might argue that it is appropriate to determine whether an architect, working full-time on a building project for an employer, is an independent contractor based on whether the architect has significant investment in training and has performed or offered to perform substantial services for others in the past year. However, these same broad statutory standards could then be applied to employees in fields with high turnover and significant training requirements, such as certain nurses working in hospital settings, to shift numerous employees to independent contractor status.

In summary, many legislative proposals establish standards that are easily satisfied or manipulable, lack clarity, and would impose alternative requirements that allow taxpayers to pick and choose elements in a manner inappropriate to the occupation or industry involved. While most workers are readily classified as employees or independent contractors, there will always be a class of cases that are less obvious. The formulation of objective, mechanical standards to resolve these cases has proven to be an elusive goal because classification under the common-law control standard looks to the realities of the situation and therefore is inherently fact-sensitive. Moreover, in light of the significant worker protections that hinge on status as an employee, it is important to consider carefully the risk that new statutory classification standards could result in significant shifts of workers from employee to independent contractor status.

Proposals for Statutory Modifications Relating to Section 530 and Tax Court Jurisdiction. Perhaps the greatest problem for business in this troubled area is not the possibility that an employer treating its employees as independent contractors will be required to reclassify them as employees for the future, but the risk of substantial employment tax liability and penalties for previous years, even where the employer had a reasonable argument and belief that it was entitled to section 530 protection.

To address this problem, we propose that Congress permit businesses that fail to meet the requirements of section 530 and misclassify workers as independent contractors to reclassify their workers prospectively with no employment tax liability for prior years, provided that they satisfy certain conditions. To qualify for this relief, the business would have to meet the section 530 reporting consistency condition, and have a reasonable argument that it meets the section 530 substantive consistency and reasonable basis requirements. This "reasonable argument" standard is intended to provide relief to taxpayers who fall just short of meeting those section 530 requirements. Of course, as under current law, if workers are correctly classified as independent contractors, or if the taxpayer meets section 530, then the business would not be required to reclassify the workers as employees.

Under the proposal, a taxpayer that believes the IRS has erred in its case would be given an expanded opportunity to obtain an independent review of the IRS decision. United States Tax Court jurisdiction would be enlarged to cover worker classification determinations for employment tax purposes. Of course, the Tax Court would have the authority described above to determine whether misclassified workers should be reclassified on a prospective basis only.

Access to the Tax Court would permit disputes to be resolved more quickly and at lower cost than in Federal district court. The Tax Court provides simplified procedures that might be adapted for small business cases. Tax Court judges have considerable experience in resolving tax cases involving similar issues, and many small cases are currently resolved without requiring the business to retain counsel. We believe that the expanded Tax Court jurisdiction would provide a business with increased access to an independent judicial resolution if the business believed its determination, rather than the IRS position, was correct.

These legislative proposals -- to eliminate past employment tax liability in certain cases where taxpayers fall just short of meeting section 530, and to increase a small business's access to an independent, third-party determination -- should further help taxpayers to resolve worker classification problems in a fair and cost-effective manner. We believe that, in combination with the administrative steps described earlier, they would provide significant relief to small businesses from the most serious problems relating to worker classification.

In addition, we believe that it may be possible to improve understanding of the common-law classification standard through a revenue ruling or other guidance. The recently revised IRS training materials take an important step in this direction by emphasizing that the true common-law test is the right to "direct and control" and that the "20 factors" that are often referred to in connection with this test are relevant only insofar as they provide evidence bearing on whether the test is satisfied. We

⁹This suggested legislative change builds on the relief provided under the IRS's Classification Settlement Program, described above.

think that it would be helpful to taxpayers for this message to be communicated through more formal guidance (such as a revenue ruling), and we also believe that such guidance could help taxpayers focus on factors -- likely five or fewer -- that are most relevant to their particular situations. At present, section 530 precludes the issuance of a revenue ruling or regulations to provide this clarification. We would be pleased to explore with Congress the possibility of amending section 530 at least to the extent necessary to permit publication of such guidance.

Proposals for Statutory Modifications Relating to Information Reporting. We believe that any proposal in this area should attempt to improve compliance with regard to independent contractors. Under current law, service-recipients engaged in a trade or business are required to report, on Form 1099, payments in the course of such trade or business to any individual independent contractor of \$600 or more during a calendar year. This information-reporting system is one of the most effective tools for enforcing proper reporting of income by independent contractors, because taxpayers are more likely to report a payment on their income tax return if they know the payment already has been reported to the IRS by the payor.

The penalty on a service-recipient for failure to file the information return, however, is only \$50 (unless the failure is due to intentional disregard of the reporting requirement). We believe this relatively minor penalty, last increased in 1982, contributes to substantial noncompliance with these reporting requirements. In recent years, many experts in this area have proposed substantially increasing this penalty. The Administration's fiscal year 1997 budget proposes to increase the general penalty for any failure to file an information return to the greater of \$50 per return (the current penalty) or 5 percent of the total amount required to be reported. Increasing the penalty in proportion to the amount of the unreported payment balances the need to have a stronger incentive to comply with the reporting rules with the concern that the penalty not be unduly harsh. The proposal includes limits on the penalty to ensure that the increase will not be imposed on those firms that have very substantially complied with the reporting requirements, <u>i.e.</u>, where the failure is likely due to inadvertence or administrative error in a firm that has made a serious attempt to fully comply with the rules. Specifically, under the proposal the penalty will not apply if the failure is corrected by August to the year the return is due. In addition, the penalty will be limited to \$50 per failure, as under current law, if the taxpayer properly reported at least 97 percent of all amounts required to be reported for that period. We note that the Tax Section of the New York State Bar Association has made a similar proposal. (See the 1995 Report on Proposed Reforms to Administration and Enforcement of Employment Tax and Income Taxes on Individual Workers.)

In addition, under current law, a service-recipient is not required to file an information return with respect to payments made to a corporation for services rendered. The Administration believes that corporations doing business with the Federal government should report as income their payments from the Federal government. Accordingly, the Administration's fiscal year 1997 budget would generally require Federal agencies to report payments of \$600 or more to corporations for services rendered, with appropriate exceptions as prescribed in regulations.

Conclusion

Worker classification is a difficult and complex issue that has far-reaching implications. Legislative changes that would result in the reclassification of workers from employee to

independent contractor status could affect a variety of protections for these workers. It is important to explore these potential consequences thoroughly before enacting any new statutory classification standard for Federal tax purposes. At the same time, we believe that Congress should consider proposals to eliminate retroactive employment tax liabilities in certain cases where an employer has a reasonable argument that it meets the requirements of section 530, and to permit taxpayers to resolve disputes with IRS in a simpler and more cost-effective

The Treasury Department appreciates the ongoing efforts by the Members of this Subcommittee and others to address this subject. We would be pleased to explore these issues further with the Subcommittee.

Madam Chairman, this concludes my formal statement. I will be pleased to answer any questions that you or other Members may wish to ask.

Chairman JOHNSON. Thank you, Mr. Lubick, and I do look forward to getting to the dialog part of this panel. I appreciate the significance of your suggestions.

Commissioner Richardson.

STATEMENT OF HON. MARGARET MILNER RICHARDSON, COMMISSIONER, INTERNAL REVENUE SERVICE; ACCOMPANIED BY STUART L. BROWN, CHIEF COUNSEL; AND MARTY WASHBURN, NATIONAL DIRECTOR, SPECIALTY TAXES

Ms. RICHARDSON. Thank you, Madam Chairman and other distinguished Members of the Subcommittee.

Chairman JOHNSON. Commissioner, before you start—

Ms. RICHARDSON. Yes, ma'am.

Chairman JOHNSON [continuing].—I do want to put clearly on the record that you have responded to the concerns raised at the White House conference in a very aggressive fashion, and I appreciate that you have put out there a new proposal for a much easier settlement process, to limiting retroactive liability to a year, to making it easier to appeal in the process of a case.

I know you are going to go into some of these things, but it does show, and putting the draft out and the training materials, So, that practitioners can come. It does open up the dialog about this, and

I commend you on your leadership.

Ms. RICHARDSON. Thank you very much, and we appreciate your support. I also want to make the point that it was not me alone who did that. I had the active and mostly enthusiastic support of many people at the IRS to help address this problem. So, I

appreciate what they have done, too.

We do appreciate the opportunity to be here. I have with me Stuart Brown who is our Chief Counsel—he is on my immediate left—and Marty Washburn who is the National Director who oversees our Employment Tax Programs. They too have been very active in helping to come up with some constructive ideas to adminis-

tratively address some of the issues that we face.

We do appreciate the opportunity to be here to talk about what we are trying to do to make the system fairer and simpler and more efficient; in particular, our improvements in employment tax administration. We have tried to respond to concerns we have heard from taxpayers, particularly small business owners, regarding the issue of worker classification, and we are trying to address them, as you pointed out, but the classification of workers as independent contractors or as employees is an issue that remains of great concern to the business community, but also, to us as well as to workers.

I want to emphasize that the Internal Revenue Service, as the tax administrator, is concerned about worker classification issues for one reason and for one reason only, and that is to perform our mission, which is to collect the proper amount of tax revenue in a fair and impartial manner. Unfortunately, though, misclassification of workers frequently does go hand in hand with noncompliance with the Federal tax laws, and so therein lies our basic interest.

Under the Internal Revenue Code, the Congress concluded that whether a worker was an employee or an independent contractor

should be determined by using the so-called common law standard, and that standard looks to whether a business has the right to direct and control the means and the details of how a worker

performs his duties.

Applying that standard has always been a difficult task. Courts have looked to a variety of evidentiary factors to establish whether that right to direct and control exists. Ultimately, we and others culled from the factors some of the evidentiary factors, and there were about 20, and they came to be known as the 20 common law factors. Ultimately, we published those in our revenue ruling, but those factors were never intended to replace the legal standard of the right to direct and control how work is performed. They were merely intended as a guide to be used in identifying what evidence might be relevant in exploring the existence and extent of the right to direct and control a worker's activities.

From the perspective of tax administration, the factors are too numerous, too complex, and they do not often fit the circumstances

of particular businesses today.

We also know that in applying the common law standard we have to take into account section 530. Many of you may recall, and as Mr. Lubick said, he was here before when this was enacted, section 530 was intended as an interim relief provision to be in effect for one year while Congress undertook full consideration of the issues that were leading to the controversies on worker classification. Unfortunately, here we are many years later still trying to discuss the issue and trying to decide how we can resolve it.

Now, I have stated publicly several times, and I want to emphasize again today, that the status of a worker as either an independent contractor or an employee is a valid and appropriate business choice. We at the IRS understand and recognize that businesses can properly classify workers as independent contractors. A worker's status must be determined accurately to ensure that workers and businesses can anticipate and meet their tax responsibilities timely and accurately, but we recognize that we at the IRS have a responsibility to make certain that the worker classification determinations under current law are accurate, even though current law has a lot of complexity.

In response to the numerous concerns both inside the Service and from taxpayers, we are changing our approach. We have recently undertaken four significant initiatives to improve adminis-

tration and to respond to the concerns that we have heard.

I would like to summarize those, although I go into much greater detail in my written testimony. First, we said that we would revise the training materials for IRS examiners that handle worker classification issues to emphasize the principle that using independent contractors can be a legitimate business practice that should not and will not be challenged by the IRS. The revised materials are based on the position I have expressed at prior hearings and in speeches that, again, we as the tax administrator have the responsibility to collect the proper amount of tax.

On March 5, we released a draft of the training materials for public comment, and for the first time ever we requested comments on our training materials. We received over 45 comment letters, and I want to thank everybody who participated. Many of the com-

ments were strongly supportive of our effort to provide a clear, evenhanded approach to this area, and almost all of the commentators had thorough, thoughtful, and constructive comments with

many useful suggestions.

We are currently reviewing the comments and revising our materials to respond to the concerns that were raised. In response to a number of comments that requested clarification of the section 530 industry practice of safe harbor, we are working with Treasury to develop a revenue procedure that will be proposed for comment and will address some of the more difficult issues that arise under that safe harbor, such as what is a significant segment, what is long-standing practice, and whether an industry is eligible for section 530 relief if the industry began after 1978.

My written testimony, again, goes into those issues in detail. We

will be happy to talk about them later.

Later this summer in July and August, over 800 examiners, managers, and reviewers in our Employment Tax Program will be retrained, and we will also be providing training for all of our general program examiners by the end of this year.

The training materials are intended to ensure that IRS examiners properly classify workers as independent contractors or as employees in a manner that is impartial and reflective of current law. I believe that these training materials will provide our examiners with the tools to do this. The materials discuss types of evidence that may indicate whether an employee-employer relationship does or does not exist under the common law standard, and they should guide examiners in determining the types of evidence that would be relevant.

The materials also address facts necessary to determine whether workers are statutory employees, and they also emphasize—and I think this is important—that relevant evidence may change over time because business relationships and the work environment can also change over time.

In addition, they address the application of section 530 since, 530 can in certain circumstances relieve employers of employment tax liability that would result from reclassification, and we are reemphasizing our policy that IRS employees are to exercise strict impartiality in the conduct of their duties.

Thus, not only are examiners required to approach the issue of worker classification in a fair and impartial manner, they are also required to actively consider section 530 during the course of an examination.

We began our draft of the training materials with the philosophy of strict neutrality in the application of the law. We also began the draft with a strong practical concern that business practices are evolving rapidly and that our evaluation of the relevant facts and circumstances must also evolve in order for us to achieve fair and impartial results.

We are going to release to the public again for the first time ever the final version of those training materials, and we welcome any additional comments. Our intention is to ensure that our training materials remain current, and we want to hear from people who are interested in good tax administration and who can help us do that. We also intend to tell businessowners what we are going to be looking for in future examinations so that they will have the opportunity to be more informed on decisions about worker classification and that they can anticipate and meet their responsibilities timely and accurately.

In addition to the new training materials, we have conducted a thorough review of our existing Employment Tax Compliance Programs. As a result, in March we also announced a new initiative we called the Classification Settlement Program which is intended to help reduce taxpayer burden by resolving worker classification issues as early in the administrative process as possible. It is based on the key principles of not reclassifying workers who have been correctly treated as independent contractors, resolving classification issues as early as possible in the administrative process, resolving those classifications uniformly throughout the country, and taking into account a taxpayer's past compliance with the common law standard and section 530 requirements in resolving these issues.

Finally, we have noted and take very seriously that our compliance programs should encourage correct classification and correct reporting of payments to workers whether they are employees or independent contractors.

We also announced in March a procedure for early referral of employment tax issues to the IRS Appeals function. The purpose of the early referral for employment tax issues is to allow them to be resolved more expeditiously through simultaneous action at the district office level and through Appeals.

Since the middle of March, taxpayers have been able to request early referral to Appeals of any developed unagreed employment tax issue that is arising out of an exam. Appropriate issues for early referral, if resolved, can reasonably expect to result in a quicker resolution of the entire case.

Finally, we require the approval of the national office for any and all large worker classification projects, including projects where the issue is the existence of an employer-employee relationship as well as those that involve, for example, employee leasing. We have taken this action because sometimes these big projects do involve large industries, and we want to ensure that we have uniform treatment throughout the country. They also often involve difficult technical issues, and we want to ensure that they are resolved at the national level.

We have reviewed and approved over a dozen worker classification projects in various market segments through this process, and we anticipate that it will make it easier for us to have uniformity across the Nation.

We also as I mentioned, have some concern about compliance. In preparing estimates of the employment tax gap, we did develop an estimate of the additional Social Security, Medicare, and Federal unemployment insurance taxes that would be due if we examined all instances of worker misclassification and if all payments to misclassified independent contractors had been treated as wages.

For 1992, we estimate that such retrospective reclassification would have produced recommendations of about \$3.3 billion in deficiencies, and after appeals and litigation those deficiencies would

have been set at \$2.6 billion. I want to underscore those employment taxes, Medicare, and FUTA taxes. The estimate does not take into account certain factors that offset the revenue loss such as the fact that independent contractors in the aggregate do tend to have fewer tax-preferred benefits than employees.

Because income underreporting contributes to the tax gap, I think it is also important to note the estimates we have on reporting compliance of misclassified compensation. On the average, misclassified workers report about 62 percent of their compensation. When 1099 Forms are filed, that greatly improves reporting, but that should be contrasted with employees whose wages are subject to withholding who report in excess of 99 percent of their wages.

We also want to thank this Subcommittee for your focus on the effect of reporting provisions on overall compliance, and we certainly welcome the opportunity to work with you and Treasury on any proposals that would be directed at improving reporting and

compliance with the reporting obligations.

The Internal Revenue Service is taking steps to ensure that the classification projects are properly focused on serious deficiencies, that our examiners are thoroughly trained in the correct application of the common law standard and section 530 of the Revenue Act of 1978, and that worker classification controversies are resolved as early as possible.

These initiatives that I have reviewed for you are all relatively new, and I think it is too soon to say how effective they will be in actually addressing the problems that have been associated with worker classification. However, I do try to regularly meet with industry and practitioner groups, and I can report that the initial response to the initiatives has generally been very positive.

We feel that these programs should ensure impartiality and consistency by the IRS, and we also want to assure that the current law is accurately reflected in worker classification, and we want to

reduce the burdens on taxpavers.

I would like to add that in areas like this where tax law interacts with business and workers in thousands of different situations, I firmly believe that the best way to ensure effective compliance in administration is to continue an open dialog between the IRS and the community. The positive effects of such a process are reflected in our new initiatives, and we continue to be encouraged as we move forward. We also want to continue to encourage comments.

This concludes my remarks, Madam Chairman. We would certainly be prepared to answer any questions that you or your

Subcommittee Members have.

[The prepared statement follows:]

STATEMENT OF MARGARET MILNER RICHARDSON COMMISSIONER OF INTERNAL REVENUE

BEFORE THE SUBCOMMITTEE ON OVERSIGHT HOUSE COMMITTEE ON WAYS AND MEANS

JUNE 20, 1996

Madame Chairman and Distinguished Members of the Subcommittee:

I appreciate the opportunity to be here today to discuss the efforts of the Internal Revenue Service to make the federal tax system fairer, simpler, and more efficient for taxpayers. In particular, I welcome the opportunity to discuss the improvements in employment tax administration, the concerns that we have heard from taxpayers, particularly small businesses, regarding the issue of worker classification, and what the IRS is doing to address these concerns.

INTRODUCTION

The classification of workers as independent contractors or as employees is an issue of great concern to the business community, the IRS, as well as to workers. How a worker is classified for tax purposes under federal and state law has broad ramifications — affecting tax liability, social security benefits, retirement, health insurance and other tax-favored fringe benefits, unemployment and worker's compensation benefits, and labor and occupational safety protections. The participants at the 1995 White House Conference on Small Business identified worker classification for tax purposes as one of their greatest concerns. In addition, last year I held a series of small business town meetings across the country during which small business owners underscored that this issue is of major importance to them.

I would like to emphasize that in analyzing a worker's status, the IRS is concerned for one reason and one reason only: to perform our mission, which is to collect the proper amount of tax revenue in a fair and impartial manner. Unfortunately, misclassification frequently results in noncompliance with federal tax laws; thus, it is an important area on which we need to continue to focus our compliance efforts.

THE COMMON-LAW STANDARD

Under the Internal Revenue Code, whether a worker is an employee or an independent contractor is determined using the common-law standard. This standard looks to whether a business has the right to "direct and control" the means and details of the worker's activities.

This standard was explicitly adopted by Congress in a 1948 resolution, enacted over President Truman's veto, which amended the Code to provide that the term "employee" would not include "(1) any individual who under the usual common-law rules applicable in determining the employer-employee relationship, has the status of an independent contractor or (2) any individual (except an officer of a corporation) who is not an employee under such common law rules." H.J. Res. 296 (62 Stat. 438). The resolution was enacted in response to proposed Treasury regulations which had defined the employer/employee relationship on the basis of the economic dependence standard suggested by the Supreme Court's decisions in <u>United States v. Silk</u>, 331 U.S. 704 (1947) and <u>Bartels v. Birmingham</u>, 332 U.S. 126 (1947). In response to the resolution, these proposed regulations were withdrawn, and the prior final regulations — which had interpreted the statutory term "employee" on the basis of the common-law test — remained in force.

Applying the common-law standard has always been a difficult task. Courts have looked to a variety of evidentiary factors to establish whether the right to direct and control exists. Because the common-law standard derives inherently from judicial decisions, the Internal Revenue Service and the Social Security Administration many

years ago reviewed the case law and listed all the types of evidence on which courts had based their decisions. Not surprisingly, different courts addressing different industries had considered different types of evidence to be relevant. All these types of evidence were placed on a single list. This list was used in training our examiners and in training by the Social Security Administration to determine whether workers are entitled to social security benefits. The list came to be known as the "twenty common-law factors" and was ultimately published, many years later, in Revenue Ruling 87-41, 1987-1 C.B. 296.

The list of "twenty common-law factors" was never intended to replace the legal standard of the right to direct and control how work is performed. It was merely intended as a guide for examiners to use in identifying what evidence might be relevant in exploring the existence and the extent of the right to direct and control.

I would like to emphasize that these factors do not answer the question of whether a worker in any specific business situation is an independent contractor or an employee. They assist in identifying the evidence that illustrates whether the requisite control exists. To apply the factors, our examiner with the assistance of the business must first determine what evidence is relevant to the business at issue. Then the examiner must determine what evidence is most important. Finally, the examiner must consider whether other evidence might be relevant. Clearly, this is not an easy process.

From the perspective of tax administration, the factors courts have used are too numerous, too complex, and often do not fit the circumstances of a particular business. However, we will continue to reexamine our approach to employment tax administration and look for new and innovative strategies to assure that workers are properly classified and that the existing statutory framework is complied with.

In addition to applying the common-law standard, section 530 must also be considered by our examiners. The enactment of section 530, as part of the Revenue Act of 1978, resulted in large part from increased IRS employment tax enforcement activities in the late 1960s. As a result of these activities, the number of reclassifications of independent contractors as employees increased substantially. In the view of many taxpayers, these reclassifications were based on a change in the IRS position of how the common-law rules applied. In response to these concerns, the Statement of Managers of the 1976 Tax Reform Act requested that the IRS "not apply any changed position or any newly stated position ... to past, as opposed to future taxable years" pending completion of a study by the staff of the Joint Committee on Taxation. See S. Rep. No. 1263, 95th Cong., 2d Sess. 210 (1978).

Section 530 was intended as an *interim* relief provision, intended to be in effect for only one year, while the Ways and Means Committee "[undertook] full consideration of the issues underlying these controversies next year [1979] in order to formulate a proposal for a comprehensive solution." H.R. Rep. No. 1748, 95th Cong., 2d Sess. 4, (1978), 1978-3 C.B. 632. Section 530 was extended several times, then made permanent in 1982. However, it has never been codified as part of the Internal Revenue Code.

Section 530 relieves taxpayers from some of the effects of reclassification if they have provided required Forms 1099, have treated consistently a class of workers as independent contractors, and have relied on some reasonable basis for not treating the workers as employees. In addition, section 530 precludes the IRS from issuing any regulations and revenue rulings concerning the subject of worker classification.

I have publicly stated several times that the status of a worker as either an independent contractor or employee is a valid and appropriate business choice. It must be determined accurately to ensure that workers and businesses can anticipate and meet their tax responsibilities timely and accurately. Our examiners should be making accurate worker classification determinations under the common-law standard, despite its complexity.

On August 2, 1995, the National Director of our employment tax programs at the IRS testified on the subject of worker classification before the Subcommittee on Taxation and Finance of the House Committee on Small Business. On that occasion, he announced that in response to numerous concerns that had been raised, the IRS was developing changes to our approach to the worker classification issue in our

employment tax audits to address taxpayer concerns. In the past months, we have undertaken four significant initiatives to improve administration in this area and respond to concerns expressed by taxpayers. I would like to describe for the Subcommittee those initiatives and their status.

WORKER CLASSIFICATION TRAINING INITIATIVE

First, we said that we would develop new training materials for IRS examiners handling worker classification issues that emphasize the principle that using independent contractors can be a legitimate business practice that will not be challenged by the IRS. These materials are based on the position I expressed in prior hearings — that the IRS, as the tax administrator, has as its sole concern in this area to collect the proper amount of tax revenue in a fair and impartial manner. On March 5, 1996, we released a draft of the training materials for public comment, the first time we have ever requested comments on training materials. This action reflects our commitment to impartiality in this area. By the end of the comment period, the IRS received over 45 comment letters. I want to thank each person and group that submitted comments.

These comments reflected the reactions of a broad spectrum of the business and labor community and included a number of letters from members and representatives of the small business community. We were delighted to find that many of the comments were strongly supportive of the effort made to provide a clear, evenhanded approach to this area. We were also pleased that almost all of the commentators went on to provide a thorough, thoughtful, and constructive analysis making a number of useful suggestions. We are currently reviewing these comments and revising our materials to respond to concerns raised. Later in my testimony I will discuss specific public comments in more detail.

We have trained a team of 20 instructors who will conduct training sessions during the months of July and August throughout the country for over 800 examiners, managers, and reviewers. We will also provide training for all of our general program examiners by the end of calendar year 1996.

The goal of the training materials is to ensure that IRS examiners properly classify workers as independent contractors or employees in a manner that is impartial and reflective of current law. The training materials provide IRS examiners with the tools to do this. They discuss types of evidence that may indicate whether an employer-employee relationship does or does not exist under the common-law standard, and guide examiners in determining the types of evidence that are relevant. They also address factors necessary to determine whether workers are statutory employees. The training materials emphasize that relevant evidence may change over time because business relationships and the work environment change over time.

In addition, the training materials address the application of section 530 of the Revenue Act of 1978. Section 530 can, in certain circumstances, relieve employers of employment tax liability resulting from worker reclassification. IRS policy requires IRS employees to exercise strict impartiality in the conduct of their duties. Thus, not only are IRS examiners required to approach the issue of worker classification in a fair and impartial manner, they are required to actively consider section 530 during an examination. Moreover, the training materials make it clear that the business need not concede or agree to the determination that the workers are employees in order for section 530 relief to be available.

As I previously stated, in order to ensure that the training materials adequately and effectively train our examiners on worker classification issues, we put them out for public comment soliciting input from the private sector including small business. I would like to take a few moments to mention some of the specific comments and what we are doing in response to them.

We began our draft of the training materials with the philosophy of strict neutrality in application of the law. We also began the draft with a strong practical concern that business practices are evolving rapidly and that our evaluation of the relevant facts and circumstances must also evolve to achieve a fair and impartial result.

We state clearly in the materials that independent contractors play a legitimate role in business operations. (Page 1-1)

- We emphasize the statutory common-law test of right to control and caution against a mechanical application of 20 factors. (Page 1-4)
- We emphasize that the nature of the business is important, and that the factors to be considered must be carefully weighed, not counted, with respect to that business. (Pages 1-5 and 1-6)
- We require that any agent conducting an employment tax examination make it his or her responsibility to raise the issue of whether the taxpayer may be entitled to relief under section 530. (Pages 1-1 and 3-33)

The commentators generally applauded this approach. However, they also offered thoughtful and constructive suggestions. We are just completing the process of revising the materials to reflect these comments and we have incorporated many of these comments into our final materials. A few examples will illustrate the range of the comments we have taken into account:

- We clarify that hourly payment and reimbursement of expenses can be consistent with independent contractor status.
- We make it clear that modern travel and communication systems have made use of a home office much less important in determining a worker's status.
- We state explicitly that a worker may wear both employee and independent contractor hats for a business — the worker can be an employee for certain services, an independent contractor for other services.
- * We make it clear that a significant segment of the industry does not require a majority of the industry, and thus, less than a majority may satisfy the industry practice safe harbor.
- We provide specific instruction about the types of evidence that may support a business' reliance on the industry practice safe harbor under section 530, stressing that taxpayer surveys, while valuable, are not essential when other evidence is available.
- We have made it clear that this safe harbor is potentially available to employers in those industries that have come into being since 1978.
- * We make clear that a practice may be long-standing even if it has not been in effect for ten years or more.
- We take the position that taxpayers who relied on the advice of a tax professional in classifying workers as independent contractors need not have investigated the employment tax expertise of the professionals in order to establish reliance on some "other reasonable basis."
- We provide that a reasonable effort by a business that falls just short of compliance with the common-law rules may be enough to establish a reasonable basis for purposes of section 530.
- In addition to requiring examiners to affirmatively raise the possibility of section 530 relief, we will develop a written plain language summary to section 530 that will be required to be provided to taxpayers at the beginning of an examination.

Also, in response to many comments regarding the difficult issue of whether a taxpayer has satisfied section 530 by virtue of reliance on a longstanding recognized practice of a significant segment of the industry in which the worker was engaged, we have worked with Treasury in developing guidance. This guidance will take the form of a proposed revenue procedure on which comments are invited. It will specifically address the points I have described above on the appropriate standard for a significant segment of the industry, the availability of the industry practice safe haven for companies within industries established after 1978, and the recognition that a practice extending beyond ten years will be presumed to meet the longstanding requirement.

Generally all of the comment letters have resulted in useful improvements to the training materials. One recurrent comment was not adopted. This comment suggested that section 530 relief should be tested without examining the worker's status under the common-law. After thorough analysis, we have not adopted this suggestion. We have included in our training materials a more detailed explanation of why determination of worker status is an important tax administration prerequisite for application of section 530 relief. We also will continue to stress that the taxpayer need not agree with or concede to our examiner's determination of status in order to obtain section 530 relief.

We intend to release to the public — again, for the first time ever — the final version of the training materials, and we welcome additional comments. It is our intention to ensure that our training remains current, and comments from those interested in good tax administration can help us do that. It is also our intention to tell business owners what we will be looking for in future examinations. This should give businesses an opportunity to make more informed decisions on worker classification to ensure that they can anticipate and meet their responsibilities timely and accurately. As the <u>Business Journal</u> in Memphis, Tennessee noted on May 6, 1996, "[t]elling [small] business owners what they're [IRS] looking for may be IRS' best weapon yet."

CLASSIFICATION SETTLEMENT PROGRAM

In addition to the development of new training materials, we conducted a thorough review of our existing employment tax compliance programs. As a result of this review, on March 5, we also announced a new initiative, the Classification Settlement Program or CSP, which is intended to help reduce taxpayer burden by resolving worker classification issues as early in the administrative process as possible. CSP will complement the worker classification training initiative I described earlier for the Subcommittee.

The CSP is based on the following key principles:

- Reclassification of workers who have correctly been treated as independent contractors must be avoided.
- Worker classification issues should be resolved quickly, and as early in the administrative process as possible.
- Worker classification issues should be resolved uniformly throughout the country.
- Resolution of worker classification issues should take into account a taxpayer's past compliance with section 530, as well as the common-law standard
- The IRS' compliance programs should encourage correct classification and correct reporting of payments to workers.

The CSP helps examiners apply these principles by giving them procedures for settling worker classification cases in the early stages of the examination based on an appropriate application of the relief provisions contained in section 530 of the Revenue Act of 1978. Under the CSP, IRS examiners offer worker classification settlements to taxpayers under examination using a standard closing agreement developed in the IRS National Office. Generally, these closing agreements provide businesses that filed Forms 1099, but do not meet all the requirements of section 530, with an opportunity to reclassify workers prospectively, combined with a specified tax assessment not exceeding one year's tax liability.

The amount of the tax assessments made under the standard closing agreements depends on the extent to which the taxpayer has satisfied the requirements of section 530. For example, a business that has complied with information reporting requirements but does not meet any of the other section 530 requirements would generally not have a tax assessment under the CSP for more than one year's liability. A business that has come closer to meeting all section 530 requirements would have a smaller tax assessment. By contrast, under the IRS' usual examination procedures, a business would generally have a tax assessment for all open tax years. Of course, taxpayers that meet all the requirements of section 530 would have neither a tax assessment nor a request from the examiner to reclassify their workers.

The graduated settlement offers comprising CSP are intended to simulate the results that would be obtained under current law, if the businesses accepting those offers had instead exercised their right to an administrative and/or judicial appeal.

The CSP provides taxpayers with an additional avenue for resolving worker classification cases as early in the administrative process as possible. Taxpayer participation in the CSP is entirely voluntary, and a taxpayer may accept a CSP settlement offer at any time during the examination process. A taxpayer's rejection of a CSP offer in no way affects the outcome of the examination. Moreover, a taxpayer declining to accept a settlement offer under the CSP retains all rights to administrative appeal that exist under the IRS' current policies and procedures.

The CSP was made available on a two-year basis beginning March 5, 1996, to all taxpayers under examination that have filed the required information returns. The IRS will evaluate the success of the CSP in resolving worker classification issues during the two-year period and invites comments businesses and practitioners may have on the program.

EARLY REFERRAL OF EMPLOYMENT TAX ISSUES TO APPEALS

Also, on March 5, 1996, the IRS issued Announcement 96-13, 1996-12, I.R.B. 33, which contains the procedures for the early referral of employment tax issues to the IRS Appeals function. The purpose of early referral for employment tax issues is to resolve them more expeditiously through simultaneous action by the District Office and Appeals. As of March 18, 1996, taxpayers may request early referral to Appeals of any developed, unagreed employment tax issue arising from an examination that is under the jurisdiction of the District Director. Early referral of employment tax issues to Appeals is:

- · Entirely optional,
- Initiated by the taxpayer, and
- Subject to the approval of both the District Director and the Assistant Regional Director of Appeals.

Appropriate issues for early referral include those that, if resolved, can reasonably be expected to result in a quicker resolution of the entire case and that both the taxpayer and District Director agree should be referred to Appeals early. Therefore, early referral may not be available for every employment tax issue.

The IRS has put the new early referral procedures into effect for a one-year period, during which time businesses and their representatives are invited and encouraged to provide feedback on the usefulness of the program.

NATIONAL OFFICE INVOLVEMENT IN WORKER CLASSIFICATION PROJECTS

Finally, we announced that we were requiring the approval of our National Office here in Washington of all large worker classification projects. This includes projects where the issue is the existence of an employer-employee relationship as well as those where the issue is the identity of the employer, for example, employee leasing. We have taken this action because these projects often involve an entire industry and we want to ensure uniform treatment of all affected taxpayers. These projects may also involve difficult technical issues, the resolution of which may require input from National Office staff. This review also ensures that any proposed project involving worker classification focuses on serious deficiencies, such as massive reclassification of workers, lack of information reporting or failure to deposit withheld trust fund taxes. In addition, National Office approval ensures that project members seek input from business people in the affected industry, and that all project members have been trained in the fair and impartial application of the existing statutory scheme of worker classification. Currently, the National Office has reviewed and approved over a dozen worker classification projects in various market segments.

TAX NONCOMPLIANCE

The Subcommittee has requested information on the amount of noncompliance attributable to misclassification of workers. Unfortunately, such estimates would be difficult to develop but we do have information that indicates the magnitude of the problem.

In preparing estimates of the employment tax gap, we developed an estimate of the additional social security, Medicare, and federal unemployment insurance taxes that would be due if the IRS examined all instances of worker misclassification, and if all payments to misclassified independent contractors had been treated as wages. For 1992, we estimate that such retrospective reclassification would have produced examiner recommendations of \$3.3 billion in deficiencies and that after appeals and litigation those deficiencies would have been set at \$2.6 billion.

We recognize, however, that the \$2.6 billion overstates, by an undetermined amount, the employment tax shortfall from worker misclassification. First, when workers are treated as employees, some of their compensation is received in the form

of fringe benefits which are not subject to tax. Thus, if workers are reclassified from independent contractor to employee status, only some of the gross payments they received as independent contractors would be taxable wages. To the extent that some compensation would be nontaxable fringe benefits, the \$2.6 billion loss is overstated.

Second, some worker misclassification results from legitimate uncertainty about the worker's status. That is what we are discussing today. Other misclassification appears to be intentional and may, in fact, merely be used as an excuse for outright tax evasion. We do not know what portion of the tax loss from worker misclassification is attributable to each cause. It seems reasonable, however, to assume that a disproportionate amount of the underreporting of income is attributable to those who are intentionally misclassified.

However much we reduce the \$2.6 billion for these two factors, we need to recognize that the \$2.6 billion is only the employment tax gap. The IRS estimates that for 1992 the income tax gap from misclassification is at least \$1.6 billion, but would be similarly reduced.

Thus, although there is uncertainty about the tax loss from misclassification and the consequent amount of increased noncompliance, we are certain that it is a significant amount, and is certainly worth expending the resources IRS has been devoting to it.

Other studies show that misclassified workers report only 62% of their compensation, but that the actual filing of Forms 1099 greatly improves reporting. Where Forms 1099 were filed, 77% of misclassified compensation was reported; where there were no Forms 1099, only 29% was reported. The IRS data also show that reporting is lower for misclassified workers than for independent contractors in general. Overal!, independent contractors report 97% of income when Form 1099 are filed and 83% when Form 1099 are not filed. Workers whose income is subject to withholding report over 97% of income.

Noncompliance Remedies

As I stated, IRS studies show that when taxpayers are aware that the IRS has received information reports on payments made to them, taxpayers are more likely to file tax returns and accurately report their income. By improving the information-reporting requirements and compliance with those requirements, we could better address this noncompliance problem. In fact, the Administration's fiscal year 1997 budget includes two legislative proposals with that objective. First, federal executive agencies would be required to report payments of \$600 or more to corporations for services rendered, with appropriate exceptions as prescribed in regulations. Second, the penalty (currently \$50) for failure to file an information return, including a return reporting payments for services, generally would be increased to the greater of \$50 or 5 percent of the amount required to be reported.

I would like to thank the Subcommittee for its focus on the effect of the reporting provisions on overall compliance. We would welcome the opportunity to work with you on any proposals directed at improving reporting and compliance with reporting obligations.

CONCLUSION

The Internal Revenue Service is taking steps to ensure that worker classification projects are properly focused on serious deficiencies, that our examiners are thoroughly trained in the correct application of the common-law standard and section 530 of the Revenue Act of 1978, and that worker classification controversies are resolved as early as possible. The tax administration initiatives I have reviewed for the Subcommittee are all relatively new, and it is too soon to say how effective they will be in addressing the problems associated with worker classification. However, I regularly meet with industry and practitioner groups, and I can report that the initial response to these initiatives has, overall, been very positive. We feel that these programs should ensure impartiality and consistency by the IRS in reviewing classification of workers as employees or as independent contractors, assure that current law is accurately reflected in classification, and reduce taxpayer burden.

I would like to add that in areas like this, where tax law interacts with businesses and workers in thousands of different situations, I firmly believe that the best way to ensure effective compliance and administration is to maintain an open dialogue between the IRS and the community. The positive effects of this process are reflected in our new initiatives and we continue to be encouraged as we move forward.

This concludes my prepared statement, Madame Chairman. I would be happy to answer any questions you or other members of the Subcommittee might have.

Chairman JOHNSON. Thank you both for your testimony. I appreciate your thoughtfulness and your leadership, and I am impressed with the changed nature of our dialog on this subject, and it should remind people that when we do things like the White House conference or when there is a real problem developing, there is in democracy a way to address it, and both the response of the executive branch and the legislative branch do reflect the sensitivity of government to the concerns of the people.

There are several specific questions I would like to ask you. First of all, have you reviewed—this is to both of you—the provisions adopted by the Senate, and do you have any comment on them?

Ms. RICHARDSON. I understand there were some changes yesterday, and I haven't had a chance to thoroughly review them, but we are concerned, as I think Treasury is, about some of the provisions, and whether or not they will address the fundamental problems that we have today in the worker classification area.

One of the concerns is that, we do need to have objective criteria in as many situations as we possibly can to avoid some of the dis-

cussions and reviews that we have today.

I know there is a provision that would require us to provide written notice of the provisions of section 530. That is a part of our proposal in the revenue procedure, and we will be making that. Whether that passes Congress or not, that will be something that we will be doing, beginning very shortly.

Chairman JOHNSON. Thank you.

In other words, in light of your testimony today, the Senate proposals do not go far enough?

Ms. RICHARDSON. Correct.

Chairman JOHNSON. I guess that would be my understanding.

Ms. RICHARDSON. Correct. We would be happy to provide more specific comments when we have a chance to digest what happened yesterday.

Chairman JOHNSON. Also, Mr. Lubick, would you be prepared to provide us with legislative language for the suggestions that you

made within the next few days?

Mr. LUBICK. We could perhaps provide detailed specifications, I think.

Chairman JOHNSON. But, I would prefer legislative language. In the end, that is what we have to do. We are rather late in this session. We are going to act on this issue, and if you could provide us

with a legislative draft of just the suggestions you proposed.

It is my personal understanding that this Senate language does not go far enough. I think in view of the work that you have done, we can actually move beyond that, but I do want to get language that we all think will be intelligible and help to radically reduce the gray area, and I would like to get that out there as soon as possible so people have a chance to respond to it.

So, the more legislative language you can provide us, the better

off we will all be.

Mr. LUBICK. We will try. Madam Chairman, you recognize, of course, that at least one of my suggestions was administrative.

Chairman JOHNSON. Yes, I do understand that, but I think the first two were legislative, were they not?

Mr. LUBICK. Yes, there were some legislative ones. We will try to be responsive.

Chairman JOHNSON. The other thing I would like your specific comment on, there were some very specific recommendations in

Rep. Jay Kim's bill in regard to reform to section 530.

Now, you have touched on some of those same issues, the Senate has touched on some of those same issues, and we just want to see where the best language is now and where it is easiest to start working from.

I was very interested in your testimony that you think it would be possible to repeal the 20-factor test. That would be, I think, a great accomplishment, but of course, we have to put something clear in its place.

Mr. LUBICK. Correct. That would require us to work with the Service very closely to come up with something that they can live with as well.

Chairman JOHNSON. Yes.

Mr. LUBICK. We intend to do that.

Chairman JOHNSON. There are a couple of things that I want to get on the record. Since it is our experience that those who report their 1099s are reporting 97 percent of their income, why has there been a focus of the compliance programs of the past on 1099 reporters, and will you be able to target your compliance efforts in the future on the noncompliers, those who aren't reporting?

Ms. RICHARDSON. We certainly do plan to have a balanced

program.

I think that our numbers show that where forms 1099 have been filed, about 77 percent of the misclassified compensation was reported. When there is no 1099, it is much lower, and then in certain segments, it can be even lower than that, but we are not just focusing on people who file 1099s.

Mr. WASHBURN. Yes. I might add to that.

Chairman JOHNSON. There does seem to be some difference of opinion as to the amount of income reported by those reporting their 1099s. The government Operations Report claims that those who do report their 1099 Forms, that in that category, workers report 97 percent of their income. So, I think we want to get clearer on that as we go forward and how much of our resources we need to focus on 1099 reporters and how much we need to focus on non-reporters.

Mr. WASHBURN. I wanted to just add, to respond to your question about why we focus on people who receive 1099s. That is just one of the tools that we use to identify possible misclassification, and GAO in a report, I believe it was 1991, recommended that we do that because it is a good way of looking at a worker who receives all of their income on a 1099 from one business. It raises a question that it is possible that he or she is an employee. It does not state that he or she is an employee.

It just raises a question, but we also initiate examinations based on SS-8s which are requests for a determination that employees normally submit concerning their status. We also raise the issue as part of our regular income tax examination. So there are a variety of ways in which we identify this potential problem.

Chairman JOHNSON. It does seem to me that the largest revenue loss would be among those not reporting their 1099s. How do you

reach that group?

Mr. WASHBURN. You are correct. The largest revenue loss is statistically by misclassified workers who do not receive a 1099. In fact, a study that we did in the past shows that the compliance level for that group is only about 29 percent. The ones who receive the 1099s is about 77 percent. So, it averaged out at about 62 percent.

Chairman JOHNSON. But the average clearly isn't the issue.

Mr. WASHBURN. Correct.

Chairman JOHNSON. I mean, you need to look at the 29

percenters.

Mr. WASHBURN. Correct. When we begin an examination, we do not know initially whether 1099s have been issued. In some cases, they have, in some others cases, they have not. Of course, our new Compliance Classification Settlement Program reflects that if a business has issued 1099s, then the settlement program applies to them. It is where they haven't issued 1099s that we do not grant them the benefits of the settlement program. So, the examination looks at all aspects of the issue.

Chairman JOHNSON. The Commissioner mentioned that it was her goal to have the government neutral in regard to these things as long as you paid your fair share of taxes. Why do you care if somebody is an independent contractor or an employee just because

they work primarily for one company? What is the tax loss?

Ms. RICHARDSON. We would not care as long as they were prop-

erly classified and properly reporting.

Chairman JOHNSON. We did have extensive testimony from those who install cable at our last hearing and in the instance of the cable industry, they had always been independent contractors. The people who lay the cable had always been independent, partly because cable companies lay cable periodically and depending on their ability to invest in that kind of capital expansion. There was

no history of any other relationship.

So, why did you choose to go in? They were all doing their 1099s. The compliance was there. What would motivate the IRS, then, to go in, especially in view of the section 530 safe harbor language? What would have motivated the IRS to go in and try to reevaluate all of these? What does it matter to you? I think government should be neutral, and my understanding is—and we talked about this yesterday, Commissioner. We will get back to this, but you are doing this now in terms of doctors that practice within a hospital. They pay their own malpractice. They set their own hours. They do not receive employee benefits and so on and so forth.

I mean, why would we devote our compliance efforts to going into relationships that are already established, have been longstanding, people who are doing their 1099s, they are clearly paying their taxes, when we have a 29-percent down here, a compliance problem, with people who aren't doing their 1099s and almost certainly

are not paying their fair shares? I do not get it.

Ms. RICHARDSON. Unfortunately, the cable issue is one that I believe is subject to section 6103 because there are some open cases on that. We would be happy to brief you and the Subcommittee

Members and your staff in private about that, but as a general proposition—

Chairman JOHNSON. Yes. I will take the general proposition.

Ms. RICHARDSON. Clearly, physicians, lawyers and other kinds of personal service providers, can have different kinds of employment relationships. They can be independent contractors. They can be employees. They can sometimes be both with different hospitals or different situations.

There is not just a general rule that necessarily applies to all doctors, but you are absolutely right that we are trying to find ways to devote our resources to the areas where we have the highest level of noncompliance, and clearly, as Mr. Washburn testified, where we have no information reporting and no withholding, those are the areas that we have the highest noncompliance, and we are trying to find ways to identify those industries or market segments, if you will, and then spend our energies there.

Chairman JOHNSON. I do appreciate how difficult it is to do that, but I do want a clear answer on why the IRS made the decision and is continuing to make the decision to go into areas where there have been longstanding relationships and it is unlikely you are going to get any more money. That just does not make sense to me.

Now, I agree with my colleague, Mr. Matsui, and with the sentiments expressed by Mr. Kleczka that we do not want to change this law in a way that identifies this business to spin people off because there are some very real disadvantages to being an independent contractor. There are some advantages, but I do need a better explanation, particularly in light of this information about examining hospitals and doctors because that may be another cable issue.

When section 530 was supposed to specifically say if this is the way you have always been doing it, we are not interested in coming in, we are interested in whether you file your 1099s and whether you are paying your fair share. Those are two different issues, but why are you initiating these, launching these efforts into areas where we have clear compliance? What does it matter to us if they are one thing or another?

Ms. RICHARDSON. In both of those areas, we would be happy to come up as soon as you like and brief you and the other Subcommittee Members.

Chairman JOHNSON. Can you give me a broader, general understanding of the rationale by which the IRS decides to go into an area where there are primarily people paying their taxes to deal specifically with reclassification?

I understand that we want people to pay their fair share. Why does reclassification matter if they are paying, they are reporting their income?

Mr. Brown. Mrs. Johnson.

Chairman JOHNSON. Yes.

Mr. Brown. May I respond to part of that?

Chairman JOHNSON. I would be happy to have you respond.

Mr. Brown. I think you have to distinguish between the aggregate numbers for compliance in particular parts of the industry and the case-by-case situation. In any particular situation, a taxpayer or an employer may have different tax results from treating their workers as either employees or independent contractors.

One difference, of course, is that you have the SECA taxes versus the employee being liable for only half the FICA taxes. You have the impact of the 2 percent——

Chairman JOHNSON. Just to that point because I think this is the guts of this matter, I mean, from the point of view of what the IRS

is choosing to do.

Under one category, you pay half of those taxes because that is the law. Now, if that is not a good law, we should change that law, but that should not be a reason why you seek to reclassify. Do you

understand what I am saying?

Mr. Brown. I think so. If an employer, if a business has a worker working for them and they improperly classify that worker as an independent contractor and the worker is, in fact, an employee, the business would have failed to pay the employer's share of the FICA taxes, and even though that might be made up, in part, in gross revenue terms by the worker's payment of the SECA taxes, the liability wouldn't be falling on the right person. While you might say that over time that difference would balance out as people adjust their behavior, looking at an individual case that has already occurred, you have that part of the liability falling in the wrong place.

There are two or three other points.

Chairman JOHNSON. There is no loss of Federal revenue.

Mr. WASHBURN. There is a loss of revenue. In other words, if you have an employer and an employee who generally both believe that there is an independent contractor relationship, the worker generally pays more, because they are paying SECA tax, which is more than they would have paid had they only paid one-half the FICA.

On the other hand, what they pay in addition to SECA tax does not offset the employer's share of the FICA, and the reason for that is that an independent contractor is entitled to deduct certain expenses without the 2-percent limitation that an employee cannot deduct. In addition, an independent contractor can deduct one-half of the SECA tax. So, there is a revenue in that.

Chairman Johnson. That is exactly my point. The revenue loss was legislated by the Congress because we thought it was fair. So, you should not try to reclassify someone to up the revenue when the Congress has legislated the policy that if you are in this category you pay less because you can take certain deductions.

Mr. WASHBURN. I am not talking about the section 530. I am just talking about where there has been misclassification and section

530 does not apply.

If section 530 applies, the revenue loss is larger, but you are ab-

solutely correct that is the intention of the Congress.

Chairman Johnson. The policy that I am challenging, what I need to understand because I do not accept, is your decision to go into areas where relationships have been long established, and yes, people are independent contractors, and yes, consequently under the law they are able to deduct business expenses. So, yes, there is a small revenue loss because they are independent contractors. That does not justify your focusing on going in and trying to reclassify them because under section 530 they clearly were not intended to be the focus of classification change.

I understand that there are some people who are being classified and treated unlike other employees in order to get them out from under, but, you see, launching an initiative into a whole industry, or a whole group or type—"industry" is too broad a word—who have been consistently treated a certain way, to say they are not paying their fair share, this is not a rationale that holds up. They are paying exactly the share we legislated they should pay.

So, revenue cannot be a reason for launching that investigation. It cannot be a justification. Section 530 safe harbor isn't a justification. So, why do you do it, especially when you have a 29 percent

compliance rate in the other categories?

Do I make myself clear? I am not a tax lawyer and I am not an expert, but I am concerned about what we are doing in terms of trying to get better compliance in an area where clearly there are problems.

Ms. RICHARDSON. I certainly cannot speak to all of the practices that have happened in the many years that have gone by, but I do know that in some of the areas that you have talked about, as well as some that we are looking at, there are practices in the industry that may vary from one part of the country to another. Sometimes, certainly even within an industry, practices vary.

What we need to do is take a closer look. There may be more than one side to this story, at least the one that you mentioned this morning, and I think that, at least based on information that we have had brought to our attention perhaps there isn't a nationwide

practice.

Chairman JOHNSON. Thank you.

Ms. RICHARDSON. That is the justification for taking a closer look.

Chairman JOHNSON. I think you do get my concern.

Mr. Kleczka.

Mr. KLECZKA. Thank you, Madam Chairman.

I think it is an interesting question that is posed by the chairperson, and the question, if I might paraphrase, is when it comes to an independent contractor, who cares. Well, I think we all should care, and in fact, I am not here to defend the IRS. We will let my friend Mr. Traficant do that, but nevertheless, I would think that your charge and your mission is tax law compliance, and as part of that law, there is a section dealing with how we term independent contractors.

If, in fact, there might be a question, then we go to section 530 and see if it fits into that category. So, who cares? You should care, because you are being paid by the taxpayers to do this not only in

this area, but naturally all tax areas.

When it comes to the employee, let us talk about what the difference between an employee and an independent contractor is. Let me just run through some things that are out there in the marketplace when it comes to employees and independent contractors, and let me ask the Commissioner to respond.

Let us try this one. Does an independent contractor benefit from

wage and welfare benefits?

Ms. RICHARDSON. No.

Mr. KLECZKA. I meant pension. Ms. RICHARDSON. The legislation.

Mr. KLECZKA. OK. Does the independent contractor from the employer or from the owner of the business get any pension or welfare benefits?

Ms. RICHARDSON. Typically not.

Mr. KLECZKA. Health care coverage?

Ms. RICHARDSON. Typically not.

Mr. KLECZKA. Unemployment compensation?

Ms. RICHARDSON. No.

Mr. KLECZKA. Worker's compensation?

Ms. RICHARDSON. No.

Mr. KLECZKA. Vacation, sick, family emergency leave?

Ms. RICHARDSON. Typically, they would not.

Mr. KLECZKA. Are they covered under the minimum wage protections?

Ms. RICHARDSON. I do not believe so.

Mr. Brown, No.

Ms. RICHARDSON. No, I do not believe so.

Mr. KLECZKA. How about Fair Labor Standards Act, overtime protections, overtime benefits?

Ms. RICHARDSON. No. I think that applies only to employees as well.

Mr. KLECZKA. How about protections under OSHA?

Ms. RICHARDSON. No.

Mr. KLECZKA. Workplace protections, occupational protections?

Ms. RICHARDSON. No.

Mr. KLECZKA. Any anti-discrimination protection under EEOC?

Ms. RICHARDSON.I am not as familiar with that. I think it typically applies to employees, but there may be a broader definition. So, I am not an authority on that.

Mr. KLECZKA. OK. How about the right to collectively bargain? Ms. RICHARDSON. Typically, that is an employee-employer

relationship.

Mr. KLECZKA. Well, as I went through this list, who cares? I care, and I think a lot of people around this country care if, in fact, it is an independent contractor-type arrangement that has precedent, that is the norm in the industry. I do not care as long as that person pays his just debts and the independent contractor pays the taxes, but for the workers who are being reclassified in an attempt on the part of the employer to save all of these benefits, I think that is very serious and we should all be concerned about that.

Let me go back to something Mr. Lubick said. What was your statement when it came to common law and the 20 factors? Did you say we should abolish them or repeal them? I do not know if

we can repeal common law.

Mr. Lubick. My suggestion was that we can do it better. The 20 common law factors, as the Commissioner stated, was not intended to be more than a catalogue that might be instructive as to things that have happened in various court decisions. I do not think it was ever intended that one employer would sit down and read that summary like a statute.

We have been prohibited from issuing guidance and interpretation to try to help people, and we do try to help people. We could withdraw that revenue ruling because it was published in a context where we are not prohibited from giving guidance, but it seems to me that it is the intent of Congress that we be restrained back in 1978 from rocking the boat, basically, by issuing new rules and

regulations.

Well, 20 years have passed without anybody knowing what we think the differentiating factors should be between employees and independent contractors and what weight should be given to various things. We think we can do better.

Mr. KLECZKA. Let me ask this, then. Would you favor avoiding the common law analysis if, in fact, section 530 is available to em-

ployees, i.e., one or the other and not both?

Mr. Lubick. Well, there are many situations where section 530 does not apply, at least it purports not to apply unless there is reasonable reliance on a number of factors. Therefore, section 530 provides and was intended to provide temporarily, only a different set of rules for one group of workers from those identically situated where the employers didn't fall within section 530. So, that has produced a strain, and if you are talking about those workers that are not working for employers entitled to section 530, they are very much in need of guidance and a restatement and an up-to-date explanation of the differentiation. It seems to me it is long overdue.

Mr. KLECZKA. Thank you.

Commissioner, is it possible for an IRS audit to grant independent contractor status to a competitor in an industry in which a majority of the other competitors have an employee-based work force?

Ms. RICHARDSON. Yes, I believe it would be as long as the people working for that business met the criteria, and the common law standard is about the right to direct and control the activities of the worker.

If you didn't do that, if you didn't, in effect, have that right to direct and control, but you told them what the results were that you wanted and said, here, go do the job and come back, and in that industry that is the way they handle their workers, whereas in every other industry people were told exactly how to do it and maybe provided with the tools and a whole host of other things that tend to be criteria looked at. Then, yes, we would be perfectly within our rights and it would be absolutely appropriate to classify those workers as independent contractors.

Mr. KLECZKA. But there would have to be some differentiation between the two competitors, i.e., how they handle their work force

and how they handle their contractors, right?

Ms. RICHARDSON. Correct. I will say that I am frequently approached, as are other people at the IRS, by businesses who feel that they are being put at a competitive disadvantage not because their competitors are properly treating their workers as independent contractors, but because they have taken workers who were employees one day, continued exactly the same relationship, and reclassified them as independent contractors the next day, and they are then put at a competitive disadvantage because they continue to pay and treat their workers as employees.

Mr. LUBICK. Mr. Kleczka, may I add to that?

Mr. KLECZKA. Sure.

Mr. Lubick. Your point is that we may have two employers with workers that are identically compensated, working under identical conditions. One employer before 1978 treated its workers as em-

ployees. That employer is never entitled to section 530. Another worker, prior to 1978, gave a looser interpretation to the common law definition and treated its employees as independent contractors. The situation was then frozen.

I have been in many situations where there are competitive disadvantages, and those employers that have to continue their classification as employees have felt seriously disadvantaged by the extension of the permission of the others to continue as independent contractors. I do not think anybody could disagree that in the long run we would all be better off if we could have a means of characterization that would allow us not to rely on section 530, but to be able to do the job right. That is what Congress had in mind when it adopted section 530. It wanted to take time out, we will freeze the situation for the moment, and then we will work out a rule that everyone can live with and everyone will be on the same level playingfield. That hasn't happened.

Mr. KLECZKA. But the situation I am thinking about is, let us say the employer with employees is pre-1978 and agrees that that is the way the situation should be, these are actual employees. Now a new company starts. A competitor starts who has taken a different track even though the independent contractors do everything that the older competitor's employees do. All right? There is where

the abuse is coming in today.

So, now what you are doing is you are forcing the older competitor, the older business, the pre-1978 business, to start looking around at how he can or she can avoid the employment laws and move for competition purposes like his new competitor to independent contractors, and that is a situation we are seeing out there in the real world. I will tell you, it is very unhealthy. It is an impetus for the employer to do so but it is unhealthy for the work status and the benefits, as I enumerated before, for the poor employee.

Ms. RICHARDSON. If they are performing precisely the same tasks and have the same arrangements and they are directly in control—

Mr. KLECZKA. A company gives them a job just like the other

company, yes, it is really close.

Mr. Lubick. That is absolutely the situation. You can have two persons who are in exactly the same situation, but because of some classification decision that was made before 1978, before section 530, the situation is frozen, and one employer can go in an absolutely opposite direction from the other.

Mr. KLECZKA. Now, is there any possibility under current law for an input by one of those competitors? Let us say you are doing an employee classification and a dispute in an industry arises. Can I as the employer with employees say, hey, wait a minute, you are moving on this classification, I think it is wrong? Is there any public input of that nature available?

Mr. LUBICK. It can only go to you, sir.

Mr. KLECZKA. OK. Thank you.

Ms. RICHARDSON. We actually get a fair amount of information about practices in various segments of industries based on people who are concerned about the competitive pressures.

Mr. KLECZKA. Thank you, Madam Chairman. I have other questions, but I think we better let some of the other Members share.

Chairman JOHNSON. Mr. Hancock. Mr. HANCOCK. Thank you very much.

There is a definite trend, and it has been going on for several years, moving more and more that the employers want to go with the independent contractors. What is the rationale for that? In your judgment, why are employers wanting to go on an independent contractor basis?

Mr. LUBICK. I would say in some cases employers do not wish to assume the paperwork burden of complying with various laws. They may not be tax laws. They may be other State regulatory laws. In some cases, they may feel that they do not want to include these workers in their pension plans and they want them to provide for their own pensions. It may be health care costs. In some cases, it may be that there is a tax avoidance motive. There are certainly situations where employers and workers have gotten together and say if you are independent I will not have to withhold on you or pay social insurance taxes, and you can do what you want. There are those cases.

I have just spent 2 years working in countries in Eastern Europe, and believe it or not, now that they are developing their own tax systems, they face this problem. It is very serious. Part of their problem is that they have social insurance contributions that may come up to 60 percent of payroll.

If you have got to pay a 60-percent tax on payroll and an income tax withholding as well, I can clearly understand why the degree of noncompliance reaches astonishing proportions.

Mr. HANCOCK. Mr. Lubick, I hope that you are studying that situation over there to avoid it in this country rather than to imple-

Mr. LUBICK. I absolutely agree with you. That is one of the

things that we have been recommending.

Mr. HANCOCK. In the real world of the small business man, one of the problems you have is the classification of employees even as far as wage and hour is concerned, a definition of who is a manager

and who is an employee, and you never know for sure.

Wage and hour, when they come in, I can fully understand why someone would switch. I haven't had any problem with it, but I am familiar with a lot of situations where once they come in, the small business man who has complied, in considering the employees, says I am going to go on an independent contractor basis if I can otherwise wage and hour will be running my business rather than me running it.

So, it would appear that as long as we continue to have all of the regulatory compliances, the question marks, the audits, the people that are almost put out of business as a result of an unintentional error and the big penalties and that type of thing, that there is going to be more and more trend toward this effort of independent contractor.

Another question that I would like to ask Mr. Wagner—is that

right?

Mr. Washburn. Washburn.

Mr. HANCOCK. Washburn. I beg your pardon.

You indicated that if an individual income tax return comes in and there is one Form 1099, you would look into that type of situation more from the standpoint of classification than you would otherwise.

Mr. WASHBURN. No. What we actually have a database of all of the Form 1099s that are filed, and we would make a computer-type run against a return to see if all of the income of a particular business was from one Form 1099, Again, that is just one of many ways that we identify potential cases. That is our job to try to identify potential problem cases. It does not mean there is a problem, but it just causes us to take a look at it.

Mr. HANCOCK. Once that particular problem is identified, that does not automatically cause a looking into the issue or the Form

1099, does it?

Mr. WASHBURN. No. Again, we have priorities. We have workload inventories. If a revenue agent was actually assigned the case, the revenue agent would make a judgment as to whether he or she wanted to pursue it, and if so they would usually send the business a letter, follow it up with a telephone call, and begin an audit. An audit is a gathering of the facts to see if there was a problem, and the audit, by the way, would usually be of the employer. I need to clarify that.

Mr. HANCOCK. I see the lights on. Can I ask one more question?

Chairman JOHNSON. Yes.

Mr. HANCOCK. Ms. Richardson, we recently held hearings on the Federal debt collection, the tax collection issues, and a significant portion of the tax debt has been classified by the Internal Revenue as currently not collectable. How much of that is attributable to payroll taxes on bankrupt taxpayers, and do you have any breakdown on what portion of these payroll taxes are from IRS reclassification determinations which resulted in the actual bankruptcy of these companies?

Ms. RICHARDSON. I actually do not have those figures in my head, but I will be happy to get them to you. I do not know that we have them broken out by that second category, but I can tell you how many are payroll taxes in the bankruptcy situations.

[The following was subsequently received:]

As of September 30, 1995, the currently not collectible (CNC) inventory equaled \$87.4 billion (not including \$6.3 billion of Trust Fund Recovery Penalty assessments that are potentially duplicative). Employment taxes comprised \$29.3 billion of the \$87.4 billion CNC.

For the same time period, \$8.7 billion of the \$87.4 billion was determined to be currently not collectible due to bankruptcy. Employment taxes comprised \$3.4 billion of the \$8.7 billion that was not collectible due to bankruptcy. Out data does not allow us to determine what portion of these payroll taxes are from IRS reclassification of workers that resulted in the actual bankruptcy of these companies.

Mr. HANCOCK. But there have been situations where a reclassification of employees have caused companies to go bankrupt.

Mr. WASHBURN. Yes. There have been cases where audits have created deficiencies that may cause a taxpayer to go bankrupt.

Ms. RICHARDSON. We will get whatever information we have.

Mr. HANCOCK. Thank you.

Chairman JOHNSON. Mr. Cardin.

Mr. CARDIN. Thank you, Madam Chairman.

Mr. Lubick, let me try to clarify your position, if I may. Chairman Johnson has asked for you to submit certain suggested legislation to this Subcommittee. You have indicated that currently

the section 530 relief is inadequate; that we cannot continue that indefinitely; that it has created inequities in the field. You also have pointed out in your testimony, your written testimony, that experience suggests that it is difficult to devise one simple specific statutory definition or safe harbor that applies appropriately to the varied existing worker relationships and occupations. Therefore, let me just ask, is Treasury suggesting that there is need for a statutory response in this matter or not?

Mr. LUBICK. We believe that a statutory approach that tries to set a bright-line safe harbor or a bright-line definition is going to fail because it will not cover all the situations. It will be manipu-

lated by clever and even not-so-clever lawyers.

I can give you an illustration. For example——

Mr. CARDIN. I understand that you are concerned about the safe harbor or a specific set of circumstances that would clearly define an independent contractor relationship.

I guess my point is, what type of statutory approach would you propose, or would you prefer to address this issue by rule and regu-

lation, and can you do it by rule and regulation?

Mr. Lubick. I think we can give much better guidance than is out there now as to how a recipient of services or an employer, without trying to beg the question, can deal with the classification situation, how he can use the factors that courts have used in a much more intelligible way than the present 20 common law factors. We can do that without the benefit of any legislation.

It seems to me there are still going to be contentions. There are still going to be differences. If, however, the consequences of those differences are not devastating to the point of causing a business to collapse under the weight of a retrospective assessment and if the business feels that there is available in the event it cannot negotiate with the IRS a reasonable solution, if there is an impartial judge at the end of the line who is available to keep everybody in line, I think we can reduce the contentiousness because much less will be at stake. There will be a better feeling that there is a fair decision.

We will try to enlighten and make it as easy as possible, but if at the end the taxpayer does not think we have done it right, there will be somebody else who will call the shot, not us.

Mr. CARDIN. So, you are basically talking about a process change—

Mr. LUBICK. A process change.

Mr. CARDIN [continuing]. But not a substantive change in the underlining statutory law.

Mr. LUBICK. Yes, sir.

Mr. CARDIN. OK. I appreciate that, and I assume that is the type of information you will be making available to the Subcommittee.

Mr. LUBICK. Yes, sir.

Mr. CARDIN. Commissioner, let me at least ask you to perhaps supply to the Subcommittee, if you are not prepared to answer

today, the point about the revenue impact on the Treasury.

All of us understand that the principal concern on an independent contractor versus employee, as far as government revenues are concerned, is whether the earnings are, in fact, reported as the earnings taxes, and you have indicated that if it is reported by

Form 1099 that there is a much better chance of compliance, if it is not reported at all then we have run into a serious compliance issue.

In response to the question by the chairman, you also indicated there is a secondary concern, and that is that an independent contractor has more flexibility in reporting certain business expenses which may have a revenue impact on the Treasury.

I am wondering whether you can supply us with information to pinpoint what we are talking about, what is the difference here. Are there documented significant revenue differences between an independent contractor and an employee in this area? Is this anywhere near the size of revenue impact of the reporting of the income for payroll taxes or income taxes?

Ms. RICHARDSON. We will be happy to provide that to you for the record, and actually in response to one of the Chairwoman's questions, we do have breakouts by types of Form 1099 as well and what the compliance is in those categories, but we will give you a more comprehensive breakout of all the information that we do have.

[The following was subsequently received:]

Worker Misclassification and Federal Tax Revenue

One of the questions that is often raised during discussions of worker classification is the impact of worker misclassification on federal tax revenue. Interest in the answer to this question, we believe, is motivated by the desire to quantify the extent of the noncompliance, i.e., the misclassification of employees as independent contractors. The terms "revenue impact" or "revenue difference", however, are somewhat confusing in this context because these terms are generally used in the context of legislative changes and revenue estimation rather than in discussions of noncompliance.

In quantifying noncompliance the IRS uses concepts such as "tax gap" and "noncompliance rate". The tax gap is defined as the difference between the amount of tax owed (i.e., "true" tax liability) and the amount of tax paid, for a given tax year. The tax gap reflects any failure to conform with tax laws and regulations, including both intentional errors due to willful and deliberate action and unintentional errors due to ignorance, oversight, interpretation, misunderstanding, or carelessness.

The IRS has developed tax gap estimates associated with misclassified compensation for social security, Medicare, and FUTA taxes. The estimate for tax year 1992 is \$3.3 billion. This total includes a social security and Medicare component of \$2.9 billion and a FUTA component of \$0.4 billion. Although the IRS's income tax gap estimates include the gaps associated with misclassified compensation, the amounts cannot be explicitly identified because the data do not separately identify misclassified compensation.

In contrast with a tax gap estimate, a revenue estimate of the impact of worker misclassification would measure the difference between the tax revenue paid under current law when employees are misclassified and the tax revenue that would be paid under current law if employers were to properly treat their workers as employees. The IRS has not developed such a revenue estimate. To do so would be extremely difficult due to the lack of data, and the end result would be subject to controversy about the validity of the assumptions needed to develop the estimate.

In summary, a revenue estimate and a tax gap estimate are not the same thing. A tax gap estimate gives the difference between two "facts"—(1) the amount of tax owed and (2) the amount of tax paid—for one set of economic conditions—those that actually occurred. On the other hand, a revenue estimate of the impact of worker misclassification would give the difference between one "fact"—the amount of tax paid—for two sets of economic conditions—(1) the conditions that actually occurred and (2) the conditions (wages paid, benefits provided, business expenses reimbursed, etc.) that would have occurred had the workers been treated properly as employees. The IRS has developed tax gap estimates related to misclassification of employees, but has not developed revenue estimates associated with this issue.

Where earnings and business expenses are reported by independent contractors.

Our interpretation of the issue at question here is the revenue impact of worker misclassification that is attributable to differences in tax treatment of business-related expenses for employees and independent contractors. Or, stated differently, are the amount of business expenses allowable to misclassified workers who correctly file tax returns as employees different from the amount of business expenses "allowable" to the misclassified workers if they incorrectly file returns as "independent contractors?"

The TCMP study of 1984 employment tax returns, which is the source of compliance data related to worker misclassification, did not collect business expense data on the misclassified workers. Therefore, we cannot provide answers to these specific questions. We can, however, make the following generalization about the revenue impact based on current law:

For a given amount of allowable business expenses, the amount deductible as an "independent contractor" will be greater than the amount deductible as an employee because of the two-percent-of-AGI limitation for itemized deductions for employees. The particular magnitude of any difference will depend on the amount of allowable expenses and AGI.

Breakout of Form 1099 compliance levels.

The table below provides compliance information related to the reporting of payments and whether the payment was reported to the IRS on a Form 1099.

Payee Income Reporting Compliance					
Name of Study	Tax Year	Type of Payment	Compliance Rate*	Was payment reported on Form 1099?	Comments
SVC-1	1984	Misclassified Wages	62.0%	Yes/No (All payments)	SVC-1 was a TCMP study of tax year 1984 employment tax returns
SVC-1	1984	Misclassified Wages	77.2%	Yes	SVC-1 was a TCMP study of tax year 1984 employment tax returns
SVC-1	1984	Misclassified Wages	28.8%	No	SVC-1 was a TCMP study of tax year 1984 employment tax returns
Delinquent Form 1099- Misc Follow-up	1977	Commissions & Fees	83.2%	No	Study based on delinquent Forms 1099 identified in tax year 1977 small corporation TCMP
Form 1099 NEC Compliance	1979	Non- employee compensation	97.4%	Yes	Estimate pertains to filers of individual income tax returns
Form 1099 NEC Compliance	1979	Non- employee compensation	92.0%	Yes	Estimate pertains to filers and nonfilers of individual income tax returns

^{*} The compliance rate is defined as the amount of compensation reported divided by the amount of compensation that should have been reported.

Mr. CARDIN. That would be helpful because most of us are working under the impression that the dollars here are mainly unreported income and failure to pay payroll taxes. We are somewhat uncertain as to whether there is a significant impact on the Treasury as it relates to the taking of business expenses.

In your statement, you point out very clearly that your principal concern is to collect the proper amount of tax revenues in a fair and impartial manner, and with that in mind, let me just under-

score the point that Mr. Gilchrest made in his testimony.

In the case of the schoolbus contractor who owns his or her own buses and pays all the payroll taxes, it is difficult for us to understand the attention that that type of a case would receive by the IRS.

Ms. RICHARDSON. That is something I am not specifically familiar with. I heard his testimony. We will certainly look into it, but I do think that is something that we need to look into, and we will.

Mr. CARDIN. Thank you very much.

Mr. LUBICK. I think, Mr. Cardin, your point is quite correct, however, that there is the secondary question as to what is the extent of noncompliance on a net income basis as opposed to the gross.

Mr. CARDIN. Correct.

Thank you.

Chairman JOHNSON. Just to clarify your testimony, Mr. Lubick, before we go on to the next panel, it is my understanding that you said, and from my notes I quote, "that we need to legislatively liberalize prospective reclassification, the right to prorespectively reclassifying where there was a reasonable error without penalty."

Mr. LUBICK. That is correct, Madam Chairman.

Chairman JOHNSON. You also said that we needed to legislatively offer new remedies, expedited appeals and so on.

Mr. LUBICK. The process items to which Mr. Cardin just

referred---

Chairman JOHNSON. Right.

Mr. LUBICK [continuing]. Require legislation, as well as the possibility if you would like us to give better guidance in this area, then the restriction currently in section 530 has to at least be loosened.

Chairman JOHNSON. I was interested in your follow-up comment that administratively you thought better guidance could result in the deletion of the 20-factor test.

Mr. LUBICK. Yes.

Chairman JOHNSON. We do want to work on that.

Mr. LUBICK. We can give better guidance if you will let us do it. Right now section 530 prohibits us from giving that guidance.

Chairman JOHNSON. Well, those are the kinds of things that we

will need to work on.

I have spoken with the Commissioner at other times, and there does seem to be an opportunity not for us to create a single bright line—I understand that that is certainly impossible—but for us to delineate the three or four most significant factors that would enable us to clarify a great deal of this. Would you agree with that?

Mr. LUBICK. I agree that we can clarify it not by a statutory bright-line test or a statutory combination of four or five bright-line tests, but I think we can make the evaluation of the factors under

the existing general test clearer, and fairer.

Chairman JOHNSON. I would mention that it was brought up in the last hearing that we might be better off to clarify and codify section 530 than to start over again because at least we have a history there. Those are the kinds of issues that we need to discuss further.

Ms. RICHARDSON. Madam Chairman, I would also like to point out that in our training materials, we have attempted to refine the factors that would go with the common law test of the right to direct and control and no longer have, the 20 factors, but things that we think are relevant to the way people are doing business today.

Some of the changes that we have made are based on comments that we have received, but they are about trying to flesh out the kinds of criteria people should be looking at. So, we are through that process trying to make the 20 factors more appropriate and frankly getting rid of many of them that aren't that relevant.

Chairman JOHNSON. I appreciate that, and that may be the best

way to go.

Also, just in light of the discussion that has taken place between you and other Members, I thought it was very interesting that your training materials indicate explicitly that a worker can be an employee for certain services and an independent contractor for others.

Ms. RICHARDSON. Correct.

Chairman JOHNSON. I think we have to be a little careful about talking too simplistically about if you are a like person then you get treated in a like way.

One of the problems is that you can be doing like services under like circumstances and still legitimately not be similarly classified.

Ms. RICHARDSON. I think that is the criteria that is significantly important in determining status. We need to spell it out so that people understand what is important and what is significant.

Chairman JOHNSON. All right. I thank the panel very much.

Mr. CARDIN. Madam Chairman, could I just very quickly?

Chairman JOHNSON. Yes.

Mr. CARDIN. There are taxpayers that are in different phases of the tax system today who must be somewhat perplexed because of the changing policy coming out of IRS in this area, and I am not being critical of IRS. It is just that this is an area in which we are trying to give clearer direction to the taxpayer, but the taxpayer may not know how to act because of the uncertainty of this area of law.

I know IRS is working on training manuals that are being revised as we speak and has announced today zero-tax settlement

agreements and there are Tax Court appeals.

I guess I would ask that we give a little bit clearer direction to the taxpayer who is trying to plan and stay out of trouble as to what is the right way to proceed, and we need to take that into consideration.

Ms. RICHARDSON. Mr. Cardin, I do not know if you were here when I mentioned that we are going to put out the final training materials. We distributed for comment the draft materials. We will make the materials available to the public for the first time so that taxpayers will understand what our agents and examiners have been trained to look for, what is expected of them, and we will do

whatever we can to publicize our expectations. We also hope that people will continue to keep us apprised of when there are changes in certain situations that ought to be taken into account and how we should modify them.

Mr. CARDIN. We appreciate that, and we might be giving you some more specific examples. We appreciate just giving the best ad-

vice we can to our constituents in this area.

Thank you, Madam Chairman.

Chairman JOHNSON. Commissioner, when you get back to us with some of the estimates that you referred to—

Ms. RICHARDSON. Yes.

Chairman JOHNSON [continuing]. Would you make clear whether those estimates are based on 1-year liability under your new settlement program or whether they are based on multi-year liability, a policy that has caused a number of difficulties, and also, whether they take into account the rough 20-percent overturn rate on appeal or whether they do not? We want to try to get as clear an understanding as we can of the revenue issues involved.

[The following was subsequently received:]

The estimates provided are "tax owed (i.e., true tax liability) and the amount of tax voluntarily paid for a given tax year. The estimate does not take into account an overturn rate on appeal.

I thank the panel very much for their participation, and let me just say that it has been my policy personally not to put the timer on for government officials who are responsible not only to help shape the law, but also, to enforce the law, and so this panel has taken longer than usual.

With the following panels, we will follow our normal procedure, a 5-minute presentation for each of the panelists and then a 5-minute question period for each of the Members.

I thank you, Commissioner Richardson and Mr. Lubick.

Ms. RICHARDSON. Thank you very much.

Mr. LUBICK. Thank you.

Chairman JOHNSON. For those on the next panel, this is the first of three 5-minute votes. That means that we will recess for about a half-an-hour. We will reconvene at 1 o'clock.

[Recess.]

Chairman Johnson. I would like to welcome Mr. Gandhi, the Associate Director of Tax Policy and Administration Issues from the GAO. I am sorry you have had to wait, and my apologies to the following panels. We will try to move along promptly, but sometimes these votes take longer than you anticipate.

Mr. Gandhi.

STATEMENT OF NATWAR M. GANDHI, ASSOCIATE DIRECTOR, TAX POLICY AND ADMINISTRATION ISSUES, U.S. GENERAL ACCOUNTING OFFICE; ACCOMPANIED BY TOM SHORT, ASSISTANT DIRECTOR, TAX POLICY

Mr. GANDHI. Thank you, Madam Chairman.

Madam Chairman and Members of the Subcommittee, we are pleased to be here today to assist the Subcommittee in its inquiry into the classification of workers either as employees or independent contractors. Joining me here on my left is my colleague, Tom Short, who has been working in this subject area for a long time.

Proper classification of workers has been the subject of several of our reports and congressional testimonies. Today I would like to

make four points.

First, in deciding how to classify workers, businesses may misclassify employees as independent contractors. In its most recent estimate on misclassification, IRS has estimated that in 1984, 15 percent of about 5 million businesses, that is, about 756,000 of them, misclassified workers as independent contractors. Many factors can cause misclassification, including cost considerations and confusion over the rules. For example, not incurring the costs of employment taxes and fringe benefits can give business cost advantages over competitors who use employees. Further, both we and the Treasury have found that the common law rules used for classifying workers are unclear and subject to conflicting interpretations.

Second, even with the confusing rules, IRS is responsible as the Nation's tax administrator to enforce compliance. Under its Employment Tax Examination Program, between 1988 and 1995 IRS has completed about 13,000 audits, resulting in some \$830 million in recommended assessments and about 527,000 workers re-

classified as employees.

Third, deliberations over any changes to the classification rules may need to consider potential impact on the income tax compliance. IRS has found that independent contractors compared to employees have lower tax compliance and account for a higher proportion of the income tax gap. We identified two alternative approaches that could boost tax compliance. They include withholding income taxes on payment made to independent contractors and improved information reporting on such payments.

Fourth and final point is that aside from tax issues, an important consideration is the body of laws that create a safety net for American workers. Such laws generally apply only to employees. If changes to the rules lead to more workers being classified as independent and contractors, these laws would cover fewer people.

Let me briefly elaborate on the concerns we have over income tax compliance by the independent contractors and the implications for

the safety net for American workers.

Since 1977, we have supported measures to simplify the classification rules. However, the development of clearer rules is neither simple nor easy. In any efforts to clarify the rules, the deliberations also may need to consider the potential impact on tax compliance.

IRS data for 1988 suggests that independent contractors accounted for most of the income tax gap created by those self-employed individuals who underreport their business income. The most recent estimates for this part of the income tax gap is about \$29 billion for 1992.

Among self-employed individuals, those who informally supply goods and services, such as street vendors and moonlighting craftsmen, reported less than 20 percent of their income, while the other self-employed individuals who operated more formally, such as gas station operators, reported less than 70 percent of their income.

Recognizing these concerns in 1992, we incentivized tax withholding and improved information reporting as alternative approaches to improved tax compliance by independent contractors, while each approach will increase to some extent the burdens on the independent contractors and businesses that use them. We believe each approach merits congressional consideration.

Finally, aside from tax issues, another consideration is the potential impact on the body of laws that create a safety net for American workers because many of these laws apply only to em-

ployees. The laws do not protect independent contractors.

For example, unemployment insurance is nearly universal, covering over 90 percent of American workers. The 60-year-old program provides short-term financial support for covered employees who through no fault of their own become unemployed. It also helps the unemployed from having to turn to public assistance programs due to economic downturns. Payments to the unemployed may take on added significance, serving a macroeconomic role of helping to stabilize the economy.

However, the Federal law does not require coverage of independent contractors for unemployment insurance. While we have not made an extensive survey to determine all affected laws, they are quite numerous. They include basic protection involving issues such as minimum wage, mandatory overtime pay, discrimination, worker's compensation insurance, and employer-sponsored fringe benefits such as pensions. If clarifications of the rules pushes significantly more employees into independent contractor status, the worker protection laws would cover fewer people.

Madam Chairman, this includes my oral testimony. I request that my written testimony be made a part of the record. My colleague and I would be pleased to answer any questions you or

other Members of the Subcommittee may have.

Thank you.

[The prepared statement follows:]

STATEMENT OF NATWAR M. GANDHI, ASSOCIATE DIRECTOR U.S. GENERAL ACCOUNTING OFFICE

Madam Chairman and Members of the Subcommittee:

We are pleased to be here to assist the Subcommittee in its inquiry into the classification of workers either as employees or independent contractors for federal tax purposes. Proper classification of workers has been the subject of several of our reports and congressional testimonies.¹ Today, I would like to make 4 points taken from these reports and testimonies.

- -- First, in deciding how to classify workers, employers may misclassify employees as independent contractors. In its most recent estimate on misclassification, IRS has estimated that 756,000 of 5.15 million employers (15 percent) misclassified workers as independent contractors in 1984. Many factors can cause misclassification, including cost considerations and confusion over the classification rules. For example, not incurring the costs of employment taxes (i.e., social security tax, unemployment tax, and income tax withholding) and employee benefits can give employers cost advantages over competitors who use employees. Further, both we and the Treasury Department have found that the common law rules used for classifying workers are unclear and subject to conflicting interpretations.
- Second, even with the confusing rules, IRS is responsible as the nation's tax administrator to enforce compliance with them. Under its Employment Tax Examination Program (ETEP), IRS has completed 12,983 audits, resulting in \$830 million in recommended tax assessments and 527,000 workers reclassified to "employee" status between fiscal years 1988 and 1995.
- -- Third, deliberations over any changes to the classification rules may need to consider potential impacts on income tax compliance. IRS has found that independent contractors compared to employees have lower compliance in paying income taxes and account for a higher proportion of the income tax gap. We identified two approaches that could boost independent contractor compliance within the existing common law rules. They include (1) improved information reporting on payments made to independent contractors and (2) withholding income taxes from such payments.
- Fourth, aside from tax issues, an important consideration in these deliberations is the body of laws that create a safety net for American workers. Such laws generally apply only to employees. If changes to the classification rules lead to more workers being classified as independent contractors instead of employees, these worker protection laws would cover fewer people.

I would like to discuss each of these points in more detail after providing an overview on factors that affect the classification decision.

These reports and testimonies include: Tax Treatment Of Employees and Self-employed Persons By the Internal Revenue Service: Problems and Solutions (GGD-77-88, Nov. 21, 1977); Tax Administration: Information Returns Can Be Used to Identify Employers Who Misclassify Workers (GAC/GGD-89-107, Sept. 25, 1989); Tax Administration: Approaches for Improving Independent Contractor Compliance (GAC/GGD-92-108, July 23, 1992); Tax Administration: Improving Independent Contractor Compliance With Tax Laws (GAC/T-GGD-94-194, Aug. 4, 1994); Tax Administration: Estimates of the Tax Gap for Service Providers (GAC/GGD-95-59, Dec. 28, 1994); and Tax Administration: Issues Involving Worker Classification (GAC/T-GGD-95-224, Aug. 2, 1995).

FACTORS IN MAKING THE CLASSIFICATION DECISION

The rules for classifying a worker as either an employee or an independent contractor come from the common law. Under common law, the degree of control, or right to control, that a business has over a worker governs the classification. Thus, if a worker must follow instructions on when, where, and how to do the work, he or she is more likely to be an employee. IRS has adopted 20 common law rules to help employers classify workers (see appendix T).

If workers are determined to be employees, employers must withhold and deposit income and social security taxes from wages paid as well as pay unemployment taxes and the employers' share of social security taxes. In addition, the employers may be subjected to laws that govern the use of employees and any benefits provided to them. Employers do not have these responsibilities if the workers are independent contractors. Independent contractors must pay their own income and social security taxes on payments received. They have no unemployment tax responsibility but may purchase benefit packages to cover this contingency as well as others (e.g., health insurance).

Ultimately, the decision to classify ϵ worker as an employee or independent contractor depends on each employer's circumstances. And, the extent to which a worker accepts the classification and understands its consequences plays a role.

COSTS AND UNCLEAR RULES CAN CAUSE MISCLASSIFICATION

Employers sometimes misclassify employees as independent contractors. For 1984, the last time IRS made a comprehensive estimate, IRS estimated that about 756,000 of 5.15 million employers had misclassified about 3.4 million workers as independent contractors. IRS interpreted the classification rules in making this estimate. As shown in appendix II, this misclassification involved all industry groups and up to 20 percent of the employers in some industry groups.

This noncompliance produced an estimated tax loss for 1984, after accounting for taxes paid by the misclassified independent contractors, of \$1.6 billion in social security tax, unemployment tax, and income tax that should have been withheld from wages. In another set of estimates, IRS issued an employment tax gap report in 1995 that included the estimated tax gap associated with misclassification. This estimated tax gap was \$2.3 billion in 1987 and \$3.3 billion in 1992 for just social security and unemployment taxes.

In doing these estimates, IRS did not identify the reasons for the misclassification but factors such as costs and unclear classification rules can play a role. For example, employers can lower their costs, such as payments of employment taxes or benefits, by using independent contractors. This cost advantage could be offset if an independent contractor can negotiate higher payments to purchase their own health, retirement, or other benefits. Otherwise, the incentive to misclassify workers as independent contractors exists.

Second, many employers struggle in making the classification decision because of the unclear rules. Until the classification rules are clarified, we are not optimistic that the confusion over who is an independent contractor and who is an employee can be avoided. The Treasury Department characterized the situation in 1991 in the same terms as it used in 1982; namely, that "applying the common law test in employment tax issues does not yield clear, consistent, or satisfactory answers, and reasonable persons may differ as to the correct classification."

In addition to confusion over the common law factors, Section 530

of the Revenue Act of 1978 has proven to be difficult to administer. Given complaints from some employers and independent contractors about IRS' attempts to reclassify independent contractors as employees, Congress passed this provision to limit IRS' reclassification authority. Section 530 provided qualifying businesses with safe harbors in determining who is an employee and an independent contractor. In 1989, we reported that, for the cases reviewed, section 530 prohibited IRS from assessing \$7 million of \$17 million in recommended taxes and penalties against employers for misclassifying employees. The employers usually avoided the assessments by claiming a prior audit protection, even when the prior audit did not address employee classification or occurred over 20 years earlier. Section 530 also has precluded IRS from issuing clarifying regulations since 1978.

IRS ENFORCEMENT

IRS is responsible as the nation's tax administrator to enforce the classification rules. Because of concerns about misclassification and income tax noncompliance by independent contractors, IRS centralized a portion of its employment tax compliance efforts into an Employment Tax Examination Program (ETEP) during 1987. IRS' strategy was to identify any misclassification and require employers to correct it. Employers whose employees are reclassified are liable for the portion of the employment taxes that they would have owed if the worker had been classified as an employee for the audited tax years.

From 1988 through 1995, IRS completed 12,983 ETEP audits. These audits recommended \$830 million in employment tax assessments and reclassified 527,000 workers as employees. In addition, the IRS Examination Division auditors, as part of their regular income tax audits, also may address classification issues. However, the Examination Division does not accumulate data to identify audit results on these issues.

Since late 1995, IRS has implemented initiatives to improve its enforcement of the classification rules and ease the burdens on those being audited. For example, IRS is revising its training to better ensure consistent application of the rules. IRS has circulated a draft of its training program so that employers know how IRS intends to interpret the rules. Further, IRS is testing ways to expedite and improve the settlement of disputes with employers over misclassification. These initiatives are too new for us to know whether they are working.

²Under section 530, IRS may not assess employment taxes for misclassified workers against an employer that had a reasonable basis for its classification, such as a reliance on (1) a judicial or administrative precedent or technical advice and letter rulings to the taxpayer, (2) a prior IRS audit that did not challenge the classification scheme, (3) an industry practice, or (4) any other reasonable basis. To qualify for this protection, the business must have filed all required information returns and have treated similar workers uniformly.

³GAO/GGD-89-107, Sept. 25, 1989.

CONCERNS OVER INCOME TAX COMPLIANCE BY INDEPENDENT CONTRACTORS

Since 1977, we have supported measures to simplify the classification rules. However, the development of clearer rules for all types of working relationships and businesses is neither simple nor easy.

In an effort to clarify the classification rules, we proposed a straightforward test in 1977 (see appendix III for details of this proposal). In sum, we proposed excluding workers from the common law definition of employee when they met each of four criteria. If the worker met three of the criteria, we proposed that the common law criteria should be applied. Otherwise, we proposed that the worker should be considered an employee. Our proposal was not widely accepted for various reasons, which we had recognized. For example, Treasury and IRS were concerned about lower tax compliance and lost tax revenue from having more self-employed workers and fewer employees.

We have viewed our 1977 proposal as a good starting point for clarifying the classification rules. In doing so, the deliberations also may need to consider the potential impact on income tax compliance. IRS studies since the 1970s have documented a much lower level of income tax compliance by independent contractors compared to employees. IRS data for 1988 suggest that independent contractors accounted for most of the income tax gap created by those self-employed individuals who underreported their business income.

IRS' most recent estimates put this part of the income tax gap at \$29.2 billion for 1992. Among self-employed individuals contributing to this tax gap, IRS estimated that those who informally supply goods and services (e.g., street vendors, moonlighting craftsmen or mechanics, unlicensed child-care providers) reported less than 20 percent of their business income. The other self-employed individuals, who operated more formally (e.g., gas station owners), reported less than 70 percent; these estimates do not distinguish between independent contractors and other self-employed individuals such as those who make or sell goods.

Recognizing these concerns, our 1992 report identified other approaches to improve independent contractor compliance within

⁴GGD-77-88, Nov. 21, 1977.

⁵The four criteria for independent contractor status included (1) separate set of books and records, (2) risk of a loss and opportunity for a profit, (3) principal place of business separate from those receiving the services, and (4) availability to provide self-employed services to the general public.

Gover the years, IRS has found that employees report almost 100 percent of their income while independent contractors report about three-quarters of theirs. A special IRS study in 1979 estimated that 47 percent of the independent contractors reported none of their business income.

^{&#}x27;GAO/GGD-95-59, Dec. 28, 1994. Lacking a generally-accepted definition of "independent contractor", the report developed estimates on service providers as a surrogate measure since many are considered by IRS and the business community to be independent contractors. Depending on the definition of service provider used, their portion of the income tax gap created by self-employed individuals ranged from 56 percent to 81 percent.

the framework of the existing classification rules. These approaches would (1) require businesses to withhold taxes from payments to independent contractors or (2) improve information reporting on payments made to independent contractors. While each approach would increase to some extent the burdens on independent contractors and businesses that use them, we believe each approach can help improve income tax compliance.

For example, withholding is the cornerstone of our tax compliance system for employees. It has worked well with over 99 percent of wages voluntarily reported. In addition, it provides a gradual and systematic method to pay taxes and better ensure credit for social security coverage. As early as 1979 we concluded that noncompliance among independent contractors was serious enough to warrant some form of tax withholding on payments to them. 9

We continue to believe that withholding taxes from payments made to independent contractors has merit as a way to improve their income tax compliance. Several administrative problems would need to be resolved. For example, independent contractors with substantial business expenses, which lower taxable income, may have too much tax withheld from gross payments made to them. Appendix IV discusses such problems and possible solutions.

A second approach to enhance compliance--improving information reporting--parallels the withholding approach by shifting emphasis from unclear classification rules to the relatively clear laws on filing information returns. ¹⁰ Focusing on information returns could have a significant effect. IRS data has indicated that when information returns are filed, misclassified workers reported 77 percent of that income on their tax returns but only 29 percent of the income not covered by information returns.

While other options may exist, our 1992 report identified eight options that could strengthen information reporting and close potential loopholes:

- (1) Significantly increase the \$50 penalty for not filing an information return.
- (2) Do not penalize businesses for past noncompliance with information reporting laws if they begin to file information returns when the penalty is increased.
- (3) Require IRS to administer an education program to make the business community aware of the filing requirement and of IRS' intention to vigorously enforce it.
- (4) Lower the \$600 reporting threshold for payments to independent contractors.
- (5) Require information reporting for payments to incorporated independent contractors.

⁸GAO/GGD-92-108, July 23, 1992. This report also discusses the tradeoffs of clarifying the section 530 safe harbors (e.g., prior audit and longstanding industry practice) and codifying section 530 for employment as well as income tax purposes.

⁹Hearing on Compliance Problems of Independent Contractors, before the Subcommittee on Select Revenue Measures, House Committee on Ways and Means, July 17, 1979.

¹⁰In general, third parties (e.g., businesses but not individual homeowners) are required to annually file information returns at IRS to report \$600 or more in payments made to unincorporated individuals for services rendered in the course of trade or business. The information is also reported to these individuals.

- (6) Require businesses to separately report on their tax return the total amount of payments to independent contractors.
- (7) Require businesses to validate the tax identification numbers (TIN) of independent contractors before making any payments and withhold a portion of the payments until the TIN is validated.
- (8) Require businesses to provide independent contractors with a written explanation of their tax obligations and rights.

Each of these options involves tradeoffs between taxpayer burden and tax compliance. Appendix V summarizes the pros and cons of each option.

IMPLICATIONS FOR THE SOCIAL SAFETY NET FOR AMERICAN WORKERS

Aside from tax issues, another consideration in deliberating changes to the classification rules is the potential impact on the body of laws that create a safety net for American workers. Because many of these laws apply only to employees, the laws do not protect workers classified as independent contractors. Changes to the classification rules could increase the number of unprotected independent contractors.

For example, unemployment insurance is nearly universal, covering over 90 percent of American workers. This 60-year old program provides short-term financial support for covered workers who, through no fault of their own, become unemployed. It also helps the unemployed from having to turn to public assistance programs. During economic downturns, payments made to the unemployed may take on added significance, serving a macro-economic role of helping to stabilize the economy. However, federal law does not require coverage of independent contractors for unemployment insurance, although one state (California) has provisions that would allow independent contractors to apply for self-coverage.

While we have not made an extensive survey to determine all affected laws, they are quite numerous. They include basic protections involving issues such as minimum wage, mandatory overtime pay, discrimination, occupational safety and health requirements, workers compensation insurance, and employersponsored fringe benefits such as pensions. Thus, if clarification of the classification rules pushes significantly more employees into independent contractor status, the worker protection laws would cover fewer people.

Madam Chairman, this concludes my testimony. I would be pleased to answer any questions you or other members of the Subcommittee may have.

APPENDIX I

IRS' COMMON LAW RULES

IRS has summarized the common law into 20 rules. The facts of each case govern which rules apply, and the weight assigned to them in classifying a worker. Even so, workers are generally employees if they:

- Must comply with employer's instructions about the work.
- 2. Receive training from or at the direction of the employer.
- 3. Provide services that are integrated into the business.
- Provide services that must be rendered personally. 4.
- Hire, supervise, and pay assistants for the employer.
- Have a continuing working relationship with the employer.
- Must follow set hours of work.
- Work full-time for an employer. 8
- Must do their work on the employer's premises. 9.
- 10. Must do their work in a sequence set by the employer.
- 11.
- Must submit regular reports to the employer.
 Receive payments of regular amounts at set intervals. 12.
- 13. Receive payments for business and/or travelling expenses.
- 14.
- Rely on the employer to furnish tools and material.

 Lack a major investment in facilities used to perform the 15. service.
- 16. Cannot make a profit or suffer a loss from the services.
- 17. Work for one employer at a time.
- 18. Do not offer their services to the general public.
- 19. Can be fired by the employer.
- 20. May quit work anytime without incurring liability.

APPENDIX II

Table 1: Estimated percentage of employers with misclassified workers, $1984\,.$

Industry	Percent of total
Construction	19.8
Finance, Insurance, Real Estate	19.3
Mining, Oil and Gas	18.6
Agriculture	16.7
Manufacturing	15.8
Services	15.4
Transportation	11.2
Wholesale and Retail Trade	9.6
Government	9.6
Not Otherwise Classified	12.6
Total	13.4

Source: Treasury Department

APPENDIX III

GAO'S 1977 PROPOSAL FOR CLARIFYING THE CLASSIFICATION RULES

To make the classification decisions more certain, we proposed a straightforward test in 1977. As in common law, our test recognized that a prime determinant of whether a worker is an employee or independent contractor is the degree of control, or right to control, the employer has over the worker. But our test also intended to recognize that some degree of control to protect the image of the manufacturer, supplier, or prime contractor should be allowed without creating an employer/employee relationship. Our test was also intended to provide a clear standard to assure better compliance. Therefore, we proposed that workers be excluded from the common law definition of employee when they:

- -- Have a separate set of books and records which reflect items of income and expenses of the trade or business;
- -- Have the risk of suffering a loss and opportunity of making a profit;
- -- Have a principal place of business other than that furnished by the persons receiving the services; and
- -- Hold themselves out in their own name as self-employed and/or make their services generally available to the public.

We also recognized that a worker may be able to meet some of our criteria and still have a valid basis for being self-employed. As a result, we proposed that the common law criteria should be applied when a worker met three of the four criteria. Otherwise, we proposed that the worker should be considered an employee.

At the time, our proposed solution was not widely accepted. Treasury and IRS were concerned that any change in the law which increases the number of self-employed would result in lost tax revenue. This was because IRS had found that self-employed taxpayers had a low compliance rate in reporting income earned. The Departments of Justice and Labor were concerned that the criteria would permit taxpayers to be considered self-employed when they have the form but not the substance of self-employment.

APPENDIX IV

ADMINISTRATIVE ISSUES CONCERNING THE POSSIBLE WITHHOLDING OF TAXES FROM PAYMENTS MADE TO INDEPENDENT CONTRACTORS

Withholding taxes from payments made to independent contractors has the potential to significantly improve their compliance with income tax laws. For this potential to come to fruition, several administrative problems would need to be resolved. The most important consideration in any withholding system is that the tax withheld approximates the tax due for the year. Independent contractors can have substantial business expenses that reduce annual net income and taxes owed. In such cases, withholding could adversely affect their cash flow. Because such expenses may vary among independent contractors, a graduated withholding system to account for differences in expenses could be used. A simpler approach for businesses would be to withhold a flat amount (e.g., 5 percent) of all payments.

Another problem is that independent contractors may circumvent withholding by incorporating. To avoid this problem, withholding would need to apply to corporations. Large corporations may view withholding on payments to them as unjustified since IRS data suggest that their voluntary compliance exceeds that of self-employed workers.

Also, it is likely that any withholding system would exempt some independent contractors. For example, the flat 10 percent withholding proposal developed by the Treasury Department in 1979 would have exempted independent contractors who (1) normally work for 5 or more businesses in a calendar year or (2) expect to owe less tax than the withheld amount. Because some independent contractors may be exempt, it would be important to complement any withholding system with an effective information reporting system.

APPENDIX V

OPTIONS FOR IMPROVING INFORMATION REPORTING ON PAYMENTS TO INDEPENDENT CONTRACTORS

In addition to discussing clearer classification rules and withheld taxes on payments to independent contractors, our 1992 report analyzed the pros and cons of eight options for improving the reporting on payments made to independent contractors, as follows.

Options	Pros	Cons
(1) Increase \$50 penalty for failure to file an information return (Form 1099-MISC).	Should improve compliance in filing Form 1099-MISC. Should increase income reported and taxes paid by independent contractors. Would encourage IRS to check Form 1099-MISC filing during audits. Would discourage agreements to not file Form 1099-MISC in exchange for lower payments.	Would complicate IRS administration if other penalties for failure to file Form 1099- MISC are \$50. Would cause equity concerns if one penalty was higher than others.
(2) Do not penalize businesses for past Form 1099-MISC. noncompliance if they begin filing.	Would encourage filing compliance. Would ease the transition to a higher penalty for not filing Form 1099-MISC.	Would not punish the noncompliance. Would result in lost penalty revenue. May foster expectation of future penalty forgiveness.
(3) Have IRS educate businesses on Form 1099-MISC filing requirements and penalties.	Should increase compliance in filing Form 1099- MISC.	Would add to IRS' costs or use funds that could be used for other educational purposes.

(4) Lower the \$600 Form 1099-MISC. reporting threshold.	Would include more payments in IRS' match to detect unfiled Form 1099-MISC forms and unreported income. Should improve independent contractor compliance. Would mirror other lower thresholds (e.g., \$10 for royalties).	Would increase costs to businesses to file more Form 1099-MISC. Would increase costs to IRS to process and match more information returns. May exceed IRS computer capacity.
(5) Require information reporting on payments made to incorporated independent contractors.	Would deter attempts to avoid information reporting. Would not need to distinguish between incorporated and unincorporated workers.	Would increase costs to file more Form 1099-MISC. Would increase costs to process and match more Form 1099-MISC. May exceed IRS computer capacity.
(6) Require businesses to report the amount of payments to independent contractors on tax returns. IRS would match these amounts to amounts reported on information returns.	Should increase Form 1099-MISC compliance. Could enhance IRS' ability to detect noncompliance. Give tax return preparers more incentive to check compliance.	May not stop some businesses from hiding payments to independent contractors. May increase businesses' costs to report the information.
(7) Have businesses validate Taxpayer Identification Numbers (TIN) before making payments and withhold taxes until a TIN is validated.	Should improve IRS matching and increase taxes collected. Should make backup withholding more cost-effective by reducing it or starting it with the first payment.	Would add burden for businesses to validate TINs before paying contractors. Would increase IRS' equipment costs.
(8) Have businesses notify independent contractors of their rights and obligations to pay taxes as selfemployed workers.	May improve tax compliance. Would encourage workers who believe they are misclassified to notify IRS. Would inform workers of their rights and obligations.	Would add burden on business to make the appropriate notifications.

Chairman JOHNSON. Thank you very much, Mr. Gandhi.

Mr. Gandhi, in your testimony you mentioned that the IRS study based on 1984 returns concluded that 15 percent of employers misclassified 3.4 million employees as independent contractors. Was this statistic based on final determinations of a worker's status after the affected taxpayers had gone through administrative appeals or litigation?

Mr. Gandhi. No.

Chairman JOHNSON. No. Normally, at least based on the Commissioner's testimony, it appears that over 20 percent of examiner reclassification recommendations are overturned during litigation and appeals. So, actually, we need to reduce those figures by about 20 percent, would you agree, to get a more realistic idea of the real impact?

Mr. GANDHI. I think there is some concern about that, but I

would have to check further on that to reply more carefully.

Chairman JOHNSON. I would like to get your thoughts on two things in regard to those statistics because they are driving policymaking and they are 12 years old.

Mr. GANDHI. Right.

Chairman JOHNSON. Especially in a society that has experienced the pace of change, in company structures, in the employee structure, in the whole economy out there, we cannot base policy decisions for the future on 1984 data. There must surely be something better, and I would like for you to get back to me both on how you would need to accommodate this data both for the impact of appeals, and for other changes that have gone on and where is there more recent data because this information is essentially useless to

Mr. GANDHI. That is correct, and I would like to make two points on that. One is that the employment audits are quite expensive audits, very costly audits. It takes a lot to do that, and the IRS is somewhat constrained with resources for that.

Chairman JOHNSON. I understand that.

Mr. GANDHI. The second point you make I think is an excellent one, which is that the working relationship has changed fundamentally.

Chairman JOHNSON. Right.

Mr. GANDHI. With the evolution of technology as a guiding force, the whole nature of work has changed, and I think that needs to be examined a little further.

Chairman JOHNSON. Also, too, because we ran into this when we were holding hearings on the big compliance audits that they do to get the kind of information that they need in a broader, more academic way, there are studies that go on in the private sector. What is there out there that might give us better information than this 1984 study?

Not only would you accommodate those figures for appeals, but also is there any way of looking at those estimates in terms of whether they involve one year of liability versus many years of

retroactive liability?

Personally, I think it is simply incredible that in an area with as much uncertainty as we have in this law that we would have imposed a retroactive settlement, unless there was very clear evidence of the goal being to circumvent the obligations of the employer, which I am sure there are cases of that sort out there, but in general, the principle of retroactively interpreting the law is a bad one, and I want to know whether those estimates of revenue loss include multiyear penalties.

Mr. Gandhi. OK.

Mr. SHORT. We do know they include multiyear. What we do not know is the portion that would be multiyear.

Chairman JOHNSON. Pardon?

Mr. SHORT. They do include multiyear retroactive assessments.

What I do not know is the portion that do.

Chairman JOHNSON. Thank you. That would be very helpful because my impression is that more often than not the IRS did impose multiyear settlements, and when we are looking now at a policy of limiting retroactivity to one year, we are not going to get the kind of revenue impact that we might have gotten.

So, we need to understand these figures much better. We need to be able to adjust them for the new policy so that we would have a better understanding. Our data is terrible, and if you could give us some help from your more independent position, we would very

much appreciate it.

Mr. GANDHI. Sure.

Chairman JOHNSON. Mr. Kleczka.

Mr. KLECZKA. Thank you very much.

I do note that you have a four-point test in your testimony, Mr. Gandhi——

Mr. GANDHI. Yes, sir.

Mr. KLECZKA [continuing]. Which, compared to the Christensen bill is much clearer and fairer, and I think the Subcommittee would do well to examine the GAO recommendations and see if possibly they could be included in any work product.

In your testimony, you did state some statistics as far as various

employee groups underreporting.

Mr. GANDHI. Yes, sir.

Mr. KLECZKA. It seems to me that those facts and figures are above and beyond the issue we are talking about today, i.e., independent contractors, I note that the street vendors and gas station owners, those are individuals involved in a cash enterprise, and like a bar or anything else, we always have a compliance problem there because there is no way to audit how much actual cash came in versus receipt by check or credit card statements. So, I just wanted to note that and maybe ask you what the implication is of this stat to the entire question of independent contractors.

Mr. GANDHI. Well, to the extent that the independent contractor issue results from around the cash transactions, you would have all of the problems that you have in the other sectors, but what we do know for sure is that the general compliance level in the inde-

pendent contractor arena is a very low one.

Mr. KLECZKA. Yes.

Mr. GANDHI. Only when you would have information reporting,

that would substantially go up.

Mr. KLECZKA. But I think if I were an employer and I had a bona fide independent contractor working with me or for me, I would want to pay him with a check so that I can prove in an audit that

this was a legitimate business expense. So, I fail to see the correlation, although I would like to know, and never will actually ascertain, how much of the independent contractor payment is in cash, but again that is going to be almost impossible to determine.

Mr. SHORT. About the closest we can get to that is an estimate based on a 1985 study done by the University of Michigan. IRS combined that information to estimate the size of the informal economy with other information it had on reporting compliance.

About half—and I do not remember the exact percentages but we can get that for you—over half of those informal suppliers provided services, and the rest provided goods. So, the possibility exists that independent contractors would be part of that population.

As far as how much of it is actually in cash, I do not know that

anyone knows that.

Mr. KLECZKA. What is the significance of reducing the threshold for filing Form 1099 from the current \$600? What will that accomplish?

Mr. GANDHI. I think if the threshold is lower, then you would have more of compliance, no question about that.

Mr. KLECZKA. You would have?

Mr. GANDHI. You would have more compliance there.

Mr. Kleczka. OK.

Mr. Short. Well, another issue is. We do not know how much because it is not required to be reported, but certain independent contractor transactions do not get reported to IRS because they fall outside of that boundary or some other boundary. So, the goal

would be to broaden the universe of Form 1099 reporting.

Mr. KLECZKA. OK. I think one of your recommendations which I favor on its face would be requiring businesses to separately report on their tax returns the total amount of payments to independent contractors. That has got to be the start, so you can track and see whether or not those contractors did report. Without this listing and I am an independent contractor, if I do not report a Form 1099 income, you are never going to know about it because there is nothing that you can cross-check or IRS can cross-check against. It does not seem like that would involve too much additional paperwork for an employer.

The other idea which I think we discussed in the previous panel, or was a question that I had that I didn't ask the other panel, was what would be your reaction to asking the filing employee or the filing independent contractor to attach to his Form 1099s that he received throughout the course of the year, like I have to attach my W-2s? What would be your reaction to that?

Mr. GANDHI. Well, I think that would increase a burden on the part of the independent contractors to do that, but I think to the extent that it improves the compliance, I would suggest that some-

thing like that ought to be considered.

Mr. Short. Yes. We haven't taken a position formally on that idea. The other issue here is the cost to the IRS to process more paper. Certainly, there would be a compliance—hopefully a positive compliance effect.

Mr. KLECZKA. Could you give me the pros and cons to requiring withholding of taxes to independent contractors?

Mr. GANDHI. Well, I think, generally, contention is made that the amount that you would withhold in the case of an independent contractor may be too much probably because of the expenses that are involved in it and that the determination of income may not be a correct one to provide the right amount of withholding, and that the independent contractor would face the cash flow problem.

On the other hand, one could suggest that as long as you have even a very small percentage, a very low percentage of the withholding, say 2 percent, 3 percent, you could get the independent

contractors into the system.

The whole issue here is that as long as the people are in the system, their compliance level increases substantially, and to the extent that the withholding is involved, then the compliance is nearly 100 percent.

Mr. KLECZKA. So, you are saying it could be a much reduced amount, just so that the person is in the system or can be tracked.

Mr. GANDHI. That is correct.

Mr. KLECZKA. Good. Thank you very much.

Mr. GANDHI. Sure.

Chairman JOHNSON. Thank you.

I did want to come back to clarify a couple of facts that I need to see if you agree with.

Mr. GANDHI. Sure.

Chairman JOHNSON. My understanding is that where the independent contractor is a legitimate independent contractor and filing their 1099, compliance is 97 percent. In other words, they are reporting 97 percent of income. Is that correct?

Mr. GANDHI. That has been a survey of an earlier time which reported 97 percent, but then there is also a survey that IRS quoted

today which is about 77 percent.

Chairman JOHNSON. That is what I want to get clear. My understanding is that IRS data shows that where 1099s are filed with regard to payments to independent contractors, it said 97 percent of the income is reported; that the 77 percent figure that the Commissioner used was in regard to people who are reclassified.

Mr. GANDHI. That are reclassified, yes, that is correct.

Chairman JOHNSON. Then the 29 percent is, in a sense, the underground, the people we are not seeing. They are not reporting anything at all, and when you do get them, they are reporting only on average 29 percent of income.

Mr. GANDHI. Correct.

Chairman JOHNSON. Do I understand that correctly?

In your testimony, you start a series of eight recommendations to increase reporting.

Mr. GANDHI. Right.

Chairman JOHNSON. We will take a very serious look at those. We do agree with you that better reporting is important, to increase penalties, trying to broaden the net of the reported participants, and we think that will enable us to ensure proper classification and also a fair share of revenue collection.

I wanted to ask you how do we better target the 29 percent and how do we target IRS' resources not at the reporters, but at the nonreporters. How do you find them? Mr. GANDHI. Well, I think the IRS needs to be very vigilant about going after the particular groups of independent contractors. For example, some independent contractors, the compliance level is less than 29 percent. So, the question here is, how do you go about doing that.

Tom, do you have something to add?

Mr. Short. Yes. I was just going to add that this is a case that you rightly pointed out, where the information return was not filed. Obviously, if the IRS can figure out ways to induce compliance by the business in filing the information return when required, either through enforcement, through education, through whatever, that 29 percent will start to change.

Chairman JOHNSON. Do you have any comment on this case, the superintendent in Maryland and the effort of IRS to reclassify bus

drivers?

Mr. GANDHI. Yes. We heard that today here, but we have

notstudied that to comment on it intelligently.

Chairman JOHNSON. I would be interested in any comment that you would have on that because that is going to have ramifications throughout the country at a time when, frankly, education dollars are at a minimum.

Mr. GANDHI. OK.

Chairman JOHNSON. Then, the last thing, you mentioned withholding as one of your recommendations, and withholding certainly makes sense, but when you look at who is an independent contractor and what their cash flow is. For example, if you lay cable, this is a professional job, and there is a regular cash flow. But a lot of these folks have very little, and I am not sure who does the withholding. I mean, administratively, this seems to be an absolute nightmare.

So, are you recommending withholding for everybody in this category or are there subcategories, and how would you just deal with

the administrative problems of withholding?

Mr. GANDHI. We are painfully aware of the administrative problems involved in withholding, and that is simply one way of looking at it.

There are groups of people that you can think about withholding and those that are being paid regularly, but one can also think in terms of improved and enhanced information reporting. Withholding is not the only way of going about doing that. It is just one of the alternatives that we are talking about, and we do realize that that would put a lot of hardship on the part of independent contractors, no question about that.

Chairman Johnson. Thank you very much. I appreciate your comments, and I will look forward to your comments on a draft that we will circulate in the near future.

Thank you very much for being with us.

Mr. SHORT. Thank you. Mr. GANDHI. Thank you.

Chairman JOHNSON. I would like to call now our first panel: Larry Campagna of Houston, Texas, on behalf of the American Bar Association Section of Taxation; Richard Reinhold, chairman of the Tax Section of the New York State Bar Association, accompanied by Sherry Kraus; Harvey Shulman, National Association of Computer Consultant Businesses, general counsel; and Debbi-Jo Horton on behalf of the Tax Implementation Chairs of the White House Conference on Small Business, Welcome.

Mr. Campagna.

STATEMENT OF LARRY A. CAMPAGNA, PARTNER, CHAMBER-LAIN, HRDLICKA, WHITE, WILLIAMS & MARTIN, HOUSTON, TEXAS, ON BEHALF OF THE AMERICAN BAR ASSOCIATION SECTION OF TAXATION

Mr. CAMPAGNA. Thank you, Chairman Johnson.

I appreciate the opportunity to present—

Chairman JOHNSON. Could you come a little closer to your microphone?

Mr. CAMPAGNA. Absolutely.

Thank you very much. I appreciate the opportunity to present the views of the ABA Tax Section today. I currently serve as chairman of the——

Chairman JOHNSON. You do have to get very close to the microphone to be heard.

Mr. CAMPAGNA. All right. I will try to swallow it.

Chairman JOHNSON. Sorry about that. Yes, just get right into it. Mr. CAMPAGNA. I currently serve as chairman of the Employment Taxes Committee of the Tax Section of the ABA, and we submitted a written statement to this Subcommittee. This morning I will try to restrict my remarks to the topics that have been under discussion already today.

I must point out at the beginning, though, that my comments are my own to the extent that they vary from the prepared statement, and that the prepared statement itself is the view of the Tax Section and not the entire ABA. There are other sections of the ABA that may not share our approach.

I also need to state for the record that I have represented a number of taxpayers in disputes over classification, and that I am not here today on behalf of any of those clients.

Mr. KLECZKA. Which side were you on?

Mr. Campagna. I have been on both sides of these disputes.

Mr. KLECZKA. Thank you.

Mr. CAMPAGNA. I just want to cover three key points this morning that are covered in the written presentation. First, that only an objective administrable definition of independent contractor status can resolve disputes over the tax classification of workers. Unfortunately, any simple administrable definition also brings social and economic costs, such as the ones that have been addressed here this morning, and therefore, it will encourage some employers to reclassify workers in order to save on health and welfare benefits.

Those problems are beyond the scope of my expertise, and so I want to address the tax consequences here this morning in my testimony.

Chairman JOHNSON. Before you go on, though, in terms of that objective administrable definition, would you be in a position to define who would be incentivized to move employees into independent contract status and who would not if we changed the definition?

Mr. CAMPAGNA. I think my approach, Madam Chairman, would be to try to adopt a definition that would preclude as much reclas-

sification as possible in that direction.

For example, if you adopted a definition that includes a certain percentage of the remuneration given to a particular person as one of the requirements for independent contractor status, for example, if it had to be less than 90 percent of the remuneration coming from one person or from one entity to be an independent contractor, then it would be difficult for companies to reclassify willy nilly.

Chairman JOHNSON. Thank you. I am sorry to interrupt you.

Please continue.

Mr. CAMPAGNA. The second point to address this morning is that despite the significant and impressive efforts by the current IRS administration to develop new training materials and settlement programs, the current law is just too ambiguous to administer

fairly and efficiently.

We appreciate the efforts the IRS has made, but section 530 is replete with undefined terms, and even more importantly, possibly, section 530 requires a result only for employment tax purposes. The safe harbors only apply for that purpose. So, the IRS still must go out and address the 20 common law factors for purposes like disqualification of employee benefit plans, whether a worker is entitled to certain deductions on Schedule C, and for other purposes.

As long as section 530 only provides relief in one area, all of the IRS' new programs will still leave disputes over worker classifica-

tion.

Third, there are numerous ways that compliance can be improved even without an objective administrable definition of an independent contractor. We have tried to list in our prepared testimony many of the suggestions that have been presented in our Committees with regard to clarifying section 530, increasing penalties for noncompliance, for example, for the failure to give a Form 1099, and other items.

This morning I would like to focus on the section 530 problems because I think that is the way that this Subcommittee could help enforce the congressional mandate of a liberal construction of that

statute.

The first suggestion, and I think the most important, is that section 530 of the Revenue Act of 1978 needs to be incorporated in the Internal Revenue Code. It just needs to be more accessible to

people out there in the community.

The second suggestion is that if section 530 safe harbor relief is applicable, it should be applicable for all tax purposes, not just for employment taxes. The Service shouldn't disqualify somebody's pension plan if they had a reasonable basis for treating a worker as an independent contractor, and the worker shouldn't lose deductions on a Schedule C if there was a reasonable basis either.

Third, the prior audit safe harbor needs to be amended in at least two ways. It should be amended to clarify that if a taxpayer is relying on an audit that began after December 31, 1996, for example, the audit must have included an examination of worker status and worker classification.

It also should be amended in a different way to prevent retroactive reclassification of workers, but permit prospective reclassification by the Internal Revenue Service if the taxpayer does not have another reasonable basis other than that prior audit, and the prior audit did not consider the classification of the workers. So, we create a two-tier system where the old audits would be divided into audits that examined employment taxes and those that did not.

The fourth suggestion is that—or fifth suggestion, I guess this would be, is that section 530 industry practice needs to be clarified. That safe harbor needs to be clarified in a number of different ways

that are listed in our prepared testimony.

Many of those suggestions, as you heard this morning, have now been incorporated by the Commissioner in the new training materials. So, I do not think there is much dispute about redefining

industry practice now.

One important point is that industry practice should be allowed as a safe harbor even if that industry practice has changed. The IRS has been out there reclassifying workers right and left, and if the industry practice has changed because the IRS forced companies to reclassify, I think the industry practice safe harbor still should be available to that company if they can show that other competitors were changed over by the IRS.

Two final points on section 530. The first is that the burden of proof under section 530 should be clarified. A taxpayer's reasonable basis argument should prevail as long as the taxpayer can demonstrate a reasonable possibility of success if the reasonable basis issue were litigated. That is a test that is applied in many areas of the tax law currently and certainly would be administrable here.

The final suggestion I would address this morning, although there are others in our materials, is that section 530 should be clarified to indicate that reasonable reliance on, and reasonable interpretation of, the 20 common law factors can be a reasonable basis for safe harbor relief. There has been dispute about that in the past.

Thank you very much for the opportunity to address the Subcommittee. Our Tax Section stands ready to help in any way, and we are happy to answer questions when our time is available this morning.

[The prepared statement follows:]

STATEMENT OF THE SECTION OF TAXATION AMERICAN BAR ASSOCIATION

June 20, 1996

Subcommittee on Oversight
of the
Committee on Ways and Means
U. S. House of Representatives
on
Employment Classification Issues

My name is Larry A. Campagna. I currently serve as Chair of the Committee on Employment Taxes of the Section of Taxation of the American Bar Association. These views are presented on behalf of the Section of Taxation. They have not been approved by the House of Delegates or the board of Governors of the American Bar Association and, accordingly, should not be construed as representing the position of the American Bar Association. We understand that the union caucus of the Labor and Employment Law Section does not concur in the views expressed in this testimony. These views are limited to the treatment of workers for income and employment tax purposes.

The classification of workers as employees or independent contractors for tax purposes has long been an area of controversy. The controversy stems from the lack of a clear and easily applied definition of either the term "employee" or "independent contractor," and the differing tax treatment accorded employees, independent contractors, and the taxpayers for whom they provide services.

In 1982, the American Bar Association adopted a formal legislative recommendation that included a five-factor test for independent contractor status. Since that time, numerous other definitions have been proposed by other professional associations and by members of Congress. We are not here today to present a proposal for a definition of an independent contractor employee, nor will we take the Subcommittee's time discussing what we believe to be the factors that should be taken into account in developing a workable definition of employee or independent contractor. We wish only to point out that the most successful resolution of the classification controversy will involve Congress developing a workable definition of an independent contractor or employee. Only an objective, administrable definition can resolve this controversy with finality.

We were specifically asked to comment today on the recent worker classification initiatives adopted by the Internal Revenue Service and to address whether those initiatives will adequately remedy the problems in worker classification. We applaud and appreciate the IRS effort to undertake these initiatives, which represent a significant improvement from both a technical and practical perspective in the administration of worker classification disputes. While we support and appreciate the efforts undertaken by the IRS in its new settlement program, the revised training materials, and the appeals policy changes, these initiatives will not solve the problems in worker classification. In fact, the IRS initiatives perpetuate many of the areas of disagreement between the IRS and taxpayers, especially on the applicability of the safe harbor relief available under Section 530 of the Revenue Act of 1978.

We recently submitted comments to the IRS regarding the draft training materials that were published by the IRS in a proposed form. While those materials would provide IRS employees with far more detailed guidance on the technical issues relating to the common law tests and Section 530 safe harbor relief, the materials still evidence a reluctance to liberally construe and administer the safe harbor rules in favor of taxpayers. Moreover, as long as the Section 530 safe harbor relief applies only for employment tax purposes, the IRS is not free to ignore the common law tests, because the common law standards still apply for income tax purposes, for disqualification of employee benefit plans, and for other matters.

Perhaps an example from the proposed training materials will illustrate the difficulties inherent in the IRS's duty to administer the current law. One of the Section 530 safe harbors prevents reclassification of workers if they were treated as independent contractors in accordance with a "longstanding recognized practice of a significant segment of the industry." The only decision from the United States Court of Appeals that has addressed the "significant segment" issue held that the taxpayer need not prove that a majority of the industry treated similar workers as contractors. Nevertheless, the IRS training materials seize on the words "recognized practice" to take the position that "there must be general consensus in the industry that treatment of workers as independent contractors is appropriate or correct." The requirement of a general consensus is not based on any judicial decision, and it essentially creates a presumption that the taxpayer must prove that a majority of the industry has accepted independent contractor treatment for similarly situated workers. This is but one example of how difficult it is for the IRS to administer this Section 530 as currently drafted. The statute is replete with ambiguous terms that need objective definition if the statute is to serve as the relief provision it was intended to be.

Similar ambiguities exist in the new settlement program undertaken by the IRS. For example, a business is eligible to settle for 25% of the employment tax liability computed pursuant to Section 3509 for one audit year if the business can show that it has met the reporting consistency requirement of Section 530 and that it has a "colorable argument" that it meets the substantive consistency requirement and the reasonable basis test. There is no definition of the term "colorable argument." In litigation, trial lawyers frequently refer to a "colorable argument" as one that is "non-frivolous." But recent informal comments suggest that the IRS expects something much more substantial than a non-frivolous argument.

On the whole, the new IRS initiatives are a welcome breath of fresh air. Nevertheless, we have objections to certain language in the proposed training materials and the settlement program. Also, the new initiatives leave unresolved a number of the pending controversies. Although the new training materials and other initiatives represent a significant step toward clarification of various IRS positions in the employment classification area, they are not the ultimate solution.

We have several suggestions that we believe will improve compliance until a definition of employee can be developed.

Prior studies have indicated that classification audits do not necessarily generate significant sums of additional tax revenues. This is particularly the case if the taxpayer has provided information returns, Forms 1099, to the Internal Revenue Service with respect to the amounts paid to its workers. The information returns permit the Internal Revenue Service to ensure that the workers have reported all of their income. Furthermore, the Internal Revenue Service's own statistics suggest that 97 percent of the amounts reported on information returns are included on taxpayers' returns. Classification audits will not uncover the entities and individuals who fail to file either tax returns or information returns, or collect any additional revenues from them.

We suggest the following changes to increase compliance until a workable definition of employee can be developed:

- 1. Incorporate the Section 530 safe harbors into the Internal Revenue Code and specifically extend them for all tax purposes, not just employment taxes. For example, if Section 530 safe harbor relief applies, then it should prevent disqualification of employee benefit plans and it also should prevent income tax adjustments to the worker's return that ordinarily would result from reclassification. This will make the rules more readily accessible to taxpayers and make the application of the Section 530 safe harbors uniform.
- 2. The application of the Section 530 prior audit safe harbor should prevent retroactive reclassification of workers, but permit prospective reclassification by the Internal Revenue Service if the taxpayer does not have another reasonable basis for its classification of its workers and the prior audit did not consider the proper classification of workers. We can see no reason to prevent the Internal Revenue Service from reclassifying workers

prospectively if the taxpayer has no basis, other than a prior audit which did not consider employment tax issues, for classifying its workers as independent contractors.

- 3. The Section 530 prior audit safe harbor should be amended to clarify whether the prior audit must have addressed employment taxes. We suggest that if the taxpayer is relying on an audit that began after December 31, 1996, the audit must have included an examination of employment taxes for the prior audit safe harbor to be applicable.
- 4. The Section 530 industry practice safe harbor should be clarified in several ways. The taxpayer should be permitted to define the industry either nationally or by the taxpayer's competitive region. A percentage test should be provided by Congress to define "significant segment of the industry" so that taxpayers and the Internal Revenue Service will have certainty in applying this rule. Congress should also clarify that an industry practice can be considered "longstanding" even if the practice began after 1978. (The proposed IRS Training Manual states that a longstanding practice is clearest if it began before 1978 but that the practice could begin after 1978.) The industry safe harbor should also permit a taxpayer to rely on industry practice even if the industry practice changes. This is particularly important if a significant segment of an industry has reclassified its workers as a result of IRS audits, so that the taxpayer will not be caught having relied on prior industry practice.
- 5. The Section 530 rule requiring consistent reporting for each worker should be modified. The IRS issued a revenue procedure (No. 85-18) years ago that clearly allows taxpayers to prospectively reclassify contractors as employees without loss of Section 530 relief. Nevertheless, the statutory language makes taxpayers reluctant to reclassify their workers as employees because doing so theoretically could eliminate the Section 530 safe harbors for periods prior to the reclassification. The consistency rule should be revised to prevent taxpayers that change their treatment of workers from employees to independent contractors from taking advantage of the Section 530 safe harbor.
- 6. The Section 530 safe harbor should be available to taxpayers even if there is no showing or admission that the workers in question are common law employees. While the IRS training materials indicate that Section 530 relief must be examined independent of the results on the common law tests, a true safe harbor relief provision should allow taxpayers to avoid completely an IRS examination of the common law test.
- 7. The burden of proof under Section 530 should be clarified. A taxpayer's reasonable basis argument should prevail as long as the taxpayer can demonstrate a realistic possibility of success if the "reasonable basis" issue were litigated. This standard is consistent with other standards required in tax practice, including those established by the IRS in Circular 230, and has been interpreted to mean approximately a 30% chance or a one-in-three chance of success in litigation.
- 8. The "other reasonable basis" safe harbor of Section 530 should be clarified to indicate that an application of the 20 common law tests can justify a taxpayer's reasonable basis.
- 9. The penalty applicable to failure to file information returns should be increased. An increase in the penalty will increase the impetus for taxpayers to file the appropriate information returns and for the Internal Revenue Service to audit in situations where reclassification of workers would not be appropriate. The penalty should not apply in deminimis circumstances where the taxpayer correctly issues information returns to most of its workers.
- 10. The amount assessable under Section 3509 for misclassification of workers should be reduced unless the misclassification is attributable to intentional disregard of rules and regulations. A reduction of the monetary consequences of reclassification will eliminate some of the controversy associated with retroactive reclassification of workers. Alternatively, taxpayers who have misclassified their worker (but without intentional disregard of rules and regulations) could be permitted to agree with the Internal Revenue Service to prospectively reclassify workers as employees rather than litigate the classification issue for prior periods.
- 11. Section 1706 of the Tax Reform Act of 1986 should be repealed, so that the safe harbor provisions will apply in the case of technical services personnel. There is little rationale for the singling out of technical services personnel for a special rule, and the definition of technical services personnel is too ambiguous to apply in today's service-oriented economy.

Chairman JOHNSON. Thank you. I appreciate your very specific testimony and look forward to working with you.

Mr. Reinhold.

STATEMENT OF RICHARD L. REINHOLD, CHAIRMAN, TAX SECTION, NEW YORK STATE BAR ASSOCIATION

Mr. REINHOLD. Thank you, Madam Chairman. I am the chairman of the New York State Bar Association Tax Section this year. I have been in private practice for 20 years. With me this afternoon is Sherry Kraus who is the author of the Tax Section's report on

independent contractor issues.

I would like to make five points. Our first point is that we think it is very important that the tax law provide clarity in terms of the distinction between an employee and an independent contractor. These are very important issues involving a lot of money for individual taxpayers both on the worker and the employer/independent contractor side, and too important to be left to the vagaries of inconsistent determinations.

Second, it is our judgment as practitioners that in very general terms independent contractor status can often result in the avoidance of significant amounts of taxes for several reasons, the first being the simple failure to report income in many cases, the second being the opportunity to overstate Schedule C expenses, and the third the opportunity to avoid the 2 percent of AGI floor on nonreimbursed expenses.

I will say in that regard that I think it is garden-variety tax advice to someone considering setting up an enterprise that independent contractor status is preferable, and there are other factors, on the very important basis that one can then be aggressive, if you will, in claiming expenses on Schedule C. So, from our point of view as practitioners, we see a lot of opportunity for tax avoidance in

independent contractor status.

The third point I would like to make is that we think that the common law control test does not work, and we similarly think that the 20 factor interpretation of that test, while a sensible interpretation of the present law, also does not work, and we think that that situation is exacerbated by changes in the modern workplace which I know you have referred to previously. People can work at remote locations. People can work with a PC and a fax, which they can supply themselves rather than having the employer supply. So, we think that the common law control test ought to be replaced with something that allows people to know clearly which side of this important issue they stand on.

Fourth, we think that the section 530 provision has outlived its usefulness. It is the antithesis of a solution rather than a solution itself. It freezes the law in one particular place and, therefore, does not permit clarification that ordinarily occurs through the litigation process and the IRS interpretive process, and it creates an unlevel playingfield that seems to us very problematic from a policy viewpoint. The changes in the 1986 act for technical service workers to get free of section 530, I think, are a good example of that.

So, in short, we think that section 530, while perhaps an appropriate patch while Congress considered the independent contractor

question, is not appropriate.

We recommend a safe harbor for independent contractor status that effectively has four elements that are described in our statement, and for persons meeting that, we would provide independent contractor status. For those who meet two or fewer of the elements, we would classify them as employees, and we think that these tests would provide very certain tax treatment for a very large number

of taxpayers.

Finally, and this is not something our Subcommittee considered, I would say that we disagree with Secretary Lubick's assertion that changing the definition of employee for tax purposes would necessarily change the definition for any State law purpose. It would be a very simple matter in drafting to make clear that a change applies only for one purpose, and if the States and so on wanted to adhere to the Federal tax definition of employee, they could either do so, or not do so.

That concludes my portion of our statement today. I would be

happy to answer any questions that you have.

[The prepared statement follows:]

Committee on Ways and Means Subcommittee on Oversight U.S. House of Representatives

Hearing on Employment Classification Issues

June 20, 1996

Statement by Richard L. Reinhold on Behalf of New York State Bar Association, Tax Section

My name is Richard Reinhold. I am currently the Chair of the Tax Section of the New York State Bar Association. The Tax Section is dedicated to achieving a fair and equitable tax system, and to the development of sound tax policy. I am a partner in the New York law firm of Cahill Gordon & Reindel. I am accompanied by Sherry Kraus, a tax lawyer from Rochester, New York; Sherry is a principal author of our 1995 report (the "report") on worker classification-related tax issues. (The report was reprinted in Highlights and Documents, October 26, 1995 at p. 1399.)

We are grateful for the opportunity to present our views today. We will make three principal points by way of background to our recommendations:

- o In light of the significant variation in taxpayer liabilities that arise from independent contractor or employee classification, and the importance of these obligations to the proper functioning of the Social Security system, it is of crucial importance that the rules for determining employee and independent contractor status be clarified.
- The so-called "control" test used to distinguish employees from independent contractors is hopelessly uncertain in its application. This ambiguity in the law creates significant costs for taxpayers and government without any concomitant benefit.
- Section 530 worsens the problems of present law by preventing clarification of the law, and by creating disparities in the treatment of businesses based on historic differences in audits (including audits that did not involve employment tax issues) or the practices in a segment of the employer's industry.

In light of these points we recommend that:

- (1) Congress adopt clear rules distinguishing employees and independent contractors. We think the safe-harbors for determining independent contractor status in certain pending bills (H.R. 582 and H.R. 1972) represent a good start, but we are concerned that the criteria used may be subject to manipulation.
- (2) Section 530 be modified in a number of respects, most importantly to (i) apply only so long as the pertinent definitional criteria are unchanged, (ii) eliminate the moratorium on pronouncements on worker classification issues by the

Internal Revenue Service and (iii) apply only as a result of an employment tax audit (as opposed to any audit).

We make other recommendations in our report at pp. 1407-10.

I will briefly summarize our reasons for these conclusions.

First, substantial differences in the worker's and employer's * tax obligations hinge on the worker's status as an employee or independent contractor. Given the probability that taxes that are not collected via withholding at source are less likely to be paid, significant revenue loss -- both employment tax and income tax -- likely attends mis-classification of employees as independent contractors. Non-compliance with employment tax requirements also impairs the functioning of the Social Security benefit system. One can only imagine the situation of an alien transported to the United States to confer with a tax advisor: he first learns that up to 39.6% may be withheld as income tax from wage-type income, that a 15.3% employment tax is also levied on such income, and that substantial life-long benefit entitlements are earned by paying the employment taxes. Presumably, the alien is then shocked to find out in many cases it is not clear whether the income taxes are withholdable, or whether it is the worker or the employer who is required to pay the employment taxes.

Second, the common-law control test now used to distinguish employees from independent contractors does not work. (This criticism applies equally to the 20-factor test used by the Service.) Aside from the most obvious cases, there are few situations where respectable arguments cannot be made on both sides. The modern work situation places even greater strain on the test, given employees' ability to work flexible hours, to work from their homes or other remote locations, and to purchase tools (e.g., fax and PC) instead of having the employer supply them (the employees' purchase of such tools need not change the essential economic relationship of the parties). While appropriate rules might be fashioned from the concepts underlying the control test (see our recommendation below in "Fifth") the test is simply not adequate to the task of distinguishing, with sufficient certainty, between employees and independent contractors.

Third, the uncertainties that bedevil present law are exacerbated by \$530 of the Revenue Act of 1978. In fact, present \$530 is the antithesis of a solution: by freezing the status quo, it prevents the law from progressing towards more rational conclusions. The result is variations in the treatment of similarly-situated workers, and preferences of one business over another. The object of \$530 -- protecting reasonable taxpayer reliance -- is certainly laudable, however, and we strongly urge that any change in the definitional standard of who is an employee be wholly prospective.

Fourth, it seems likely that, in general, independent contractor treatment probably results in avoidance of worker taxes for several reasons, including failure to include amounts paid in income, overstatement of Schedule C expenses and

^{*} I will use the term "employer" as shorthand for both the employer as well as the service recipient in an independent contractor relationship.

avoidance of the 2% of AGI floor on deductibility of unreimbursed expenses. Employers may favor independent contractor status for non-tax reasons (a desire not to afford qualified plan or medical benefits) or tax-motivated reasons (reduced wages acceptable due to absence of tax withholding). From a compliance viewpoint, employee status and withholding of tax generally is preferable, except in cases such as those involving significant employee expenses where employee treatment is impractical.

Fifth, although some rough justice in defining who is an employee is probably necessary, many situations can be addressed adequately through safe-harbors. For example, an independent contractor might be required to satisfy each of four substantive tests: (1) the worker could suffer a loss from the services (due to the incurrence of expenses, including depreciation), (2) the worker has a separate principal place of business from the employer's, (3) the worker has a significant investment in facilities or tools not typically maintained by an employee and (4) the worker makes his or her services available to the public and has performed substantial services for at least two unrelated employers in the current year or the preceding year. We are concerned that a measure that allows reliance on a single factor may be subject to manipulation. For example, a worker might in all respects resemble a traditional employee except that he might hold himself out as available to third parties and briefly work for another employer, or might work from quarters adjacent to his home using a PC. These workers would nonetheless be classifiable as independent contractors under H.R. 582 and H.R. 1972.

Sixth, §530 ought to be revised in a number of respects. As noted, we would remove the bar on IRS interpretation of employee status issues. Additionally, we would limit §530 relief to cases where the audit that forms the basis for taxpayer reliance focused specifically on employment tax issues affecting the individual in question or similarly situated individuals.

Chairman JOHNSON. I would like for you to answer questions when we finish with the panel, but I would like for Ms. Kraus to go through the more specific recommendations that you have made, especially in light of your recommendation that we not, in a sense, clean up section 530.

STATEMENT OF SHERRY S. KRAUS, INDIVIDUALS COMMITTEE, TAX SECTION, NEW YORK STATE BAR ASSOCIATION, AND CO-AUTHOR OF "TAX SECTION REPORT"

Ms. KRAUS. All right, Madam Chairman. Thank you.

I would just like to start at the beginning with a very important point that is made in our report, which is that any changes and reforms in the worker classification area must go hand in hand with reforms in the compliance area.

Our report goes extensively into the problems, the huge exemptions in reporting under Form 1099 where even if an employer is in full compliance, there are many payments that go out to workers that do not require Form 1099 reporting. You have heard this morning, of course, a lot of statistics regarding the tax gap with the self-employed. So, much of that, it seems likely, is due to the fact that there is just nothing going into the IRS on these payments, including, for example, a building contractor who works for a homeowner and may put on a \$70,000 addition. There is nothing going into the IRS on that at all because of the domestic employer exemption from form tax reporting.

In our town in upstate New York, many businesses will ask their workers to incorporate. All the worker has to do is pay \$300 to incorporate, and suddenly that exempts the employer from 1099 reporting. So, there are massive gaps and exemptions here that do

create a problem.

If we are going to reform the worker classification area, we have to reform the tax reporting and compliance area so that the decision of whether you are an independent contractor or an employee truly is a tax-neutral decision, and so we no longer have this tension of if you are an independent contractor you can get by with

underreporting and if you are an employee you cannot.

We also in our report reviewed the bills that were before Congress at that time, including the Kim and Christensen bills. I would like to comment that while we agree with the approach of having certain objective criteria determine a safe harbor for independent contractors, we found those bills not to be the solution. While the bias right now at the IRS is toward employee characterization, we believe that under either one of these bills, the pendulum would swing greatly to the other end of the spectrum and make it too easy to be an independent contractor, thus, undermining employee status altogether.

What we did in our report, and Rick adverted to it, is we agree that there needs to be objective bright-line tests not only for independent contractors, but also, for employees, We cherry-picked through the bills, and looked at case lawand tried to pick the factors that we believed truly are the elements for independent contractor status. They are in the report and summarized as follows:

One would be whether the worker could suffer a loss. It is very unusual for an employee to be able to actually suffer a loss in his/

her business. We look at whether the worker maintains a principal place of business, separate from the employer, has a significant investment in facilities and tools, makes his services generally available to the public, has worked for more than one employer in the last year, has a written agreement with his employer specifying that he will be treated as an independent contractor and will assume the liabilities and obligations to report consistently, and has to maintain his own books and records. If the worker meets all of those criteria, the worker would be classified as an independent contractor. Then we make an attempt to say what criteria should define employee status. If the worker works for an employer for 20 hours or more and meets two or fewer of the criteria for the independent contractor classification, the worker will meet bright-line test of being classified as an employee.

Now, we believe this will take care of the vast majority of disputed issues under current law. However, there will be some workers that do not fall into either of these tests, and for those in the middle, we would continue to apply the common law test, but we would recommend removing the moratorium on Treasury under section 530 to allow Treasury and the IRS to give us greater guidance in the area, so that for the workers who do have to be under

this test, then you can have better criteria.

We also look at the section 530 safe harbor that Rick was talking about. We recommend the codification of that safe harbor. However, we also recommend some tightening of that safe harbor. We think the present audit safe harbor is over-board. For example, the IRS should not be bound if they go in and do any type of audit. The IRS does not always audit everything, and if they simply audit an income tax area, the employer should not be protected in perpetuity from ever having to reclassify his workers to the appropriate classification by reason of the private audit safe harbor rule. So, we agree with recommendations that the prior audit safe harbor be restricted to employment tax audits only. We also make a recommendation that has not been discussed today which is the statute of limitations. At the present time, there is nothing to prevent the IRS from going back indefinitely, well more than 3 years, in making these assessments, and they do. We recommend a procedure for allowing certain electing employers to start the statute of limitations running so that they will not be exposed for more than 3 years in the event they are erroneously classifying their workers. We then turn to recommended reforms in the compliance area, the most important of which is to increase the penalty on employers who do not do the Form 1099 reporting as required.

Right now the penalty is nominal. Employers have no great risk if they decide not to send the Form 1099, or if they enter into some agreement with their worker, collusively, not to report the pay-

ments. Then we need the penalty stiffened.

We also need to make it easier for the employer to verify the 10 numbers for those who do want to comply. Right now the system is very cumbersome. If a worker gives you a wrong number, a wrong Social Security number, it is more than a year later before the employer knows about it. So, a lot of money is lost to the system that way. Basically, the other primary recommendation is to

lower the threshold for reporting on Form 1099, and you talked to

the gentleman from GAO about that.

Right now there are too many exemptions from Form 1099 reporting. If the employer pays the worker less than \$600, he does not have to send a Form 1099. If the worker incorporate—that only costs \$300 or so in New York to incorporate—the employer does not have to send a Form 1099. If the worker works for a domestic employer, you do not have a Form 1099 going into the IRS.

We also need the \$600 threshold lowered so that more reporting goes in. We need to get rid of the incorporation shelter at least as to workers who do it to avoid reporting at all. Basically that is our

detailed summary of our report recommendations.

[The prepared statement follows. The full report is being held in the Committee's files.]

HOUSE WAYS AND MEANS COMMITTEE SUBCOMMITTEE ON OVERSIGHT HEARING ON EMPLOYMENT CLASSIFICATION ISSUES

Summary of Recommendations in Report Submitted by New York State Bar Association, Tax Section

Sherry S. Kraus, Co-Principal Author of Report

The Tax Section undertook a review of the employment classification area and issued a report on October 16, 1995 making recommendations for reform. As requested, a copy of the report is attached for inclusion in the Subcommittee's hearing record.

This is an area long overdue for reform. Employers need reform because, as to many workers, they must apply vague guidelines in the decision of whether to classify that worker as an independent contractor or an employee. Furthermore, employers have no easy, inexpensive means for review by the Internal Revenue Service as to whether that classification is correct. This is particularly troubling since, under current interpretations of the law, employers face an unlimited statute of limitations for deficiency assessments if they have incorrectly treated a worker as an independent contractor when the worker should have been treated as an employee. For this reason and the fact that mistakes often affect large categories of workers, employers face potentially devastating deficiency assessments in worker reclassifications.

The Treasury and the Internal Revenue Service agree that there are problems in applying the common-law criteria to determine the appropriate classification of a worker. Treasury has noted that the present method for classification "does not yield clear, consistent or satisfactory answers and reasonable persons may differ as to the correct classification." In a study involving tax year 1992, it was estimated that worker misclassifications resulted in lost tax revenue in the range of 2.1 billion dollars.

Nor is this an issue that affects only small business employers who, historically, have been more likely to hire independent contractors and other short term workers than large business. As evidenced by the recent tax audit of IBM, the problem is now extending into the highest reaches of corporate America as a consequence of corporate downsizing and the significant economic advantages of hiring the worker back as a consultant with independent contractor status.

The worker can be caught in the middle. There are significant economic savings to an employer who treats the worker as an independent contractor instead of an employee. As to that worker, the employer does not have (a) to pay employment taxes, (b) to withhold employment and income taxes, (c) to pay FUTA taxes, (d) to meet extensive filing and record-keeping requirements or (e) to include the worker in the employer's qualified health, disability or pension plans. Because of these potential economic savings to the employer, the worker may be pressured into agreeing to be treated as an independent contractor in order to have the job even if such might not be the appropriate classification for the worker.

On the other side of the coin is the worker who may press his employer to be treated as an independent contractor rather than as an employee. Notwithstanding the greater employment tax costs to the worker from independent contractor status, a cash strapped worker may seek this treatment to increase cash flow by avoiding income and employment tax withholding that would be required if the worker were treated as an employee. Unscrupulous workers might seek this classification with the intention of more easily avoiding tax compliance by underreporting or nonreporting of payments received. On this point, it should be noted that the lost tax revenues from misclassification of workers (2.1 billion dollars in 1992) pales in comparison to the lost tax revenue from under reporting of income by self-employed workers (estimated to be 20.3 billion dollars

in 1992). Currently, the ability of the Service to improve reporting compliance by selfemployed workers is undercut by existing laws that are inadequate to the task.

Studies support the conclusion that self-employed workers have a significantly higher level of compliance in reporting payments made to them if the payments have been reported to the Internal Revenue Service by their employers on Form 1099-MISC. Unfortunately, there are many exceptions to an employer's obligation to file an information return on Form 1099 for payments made to independent contractors. If, for example, (a) the worker incorporates, (b) the worker receives payments of under \$600 a year, or (c) the worker provides services to a non-business employer such as a homeowner, no return is required. Accordingly, these payments will not be reported to the IRS for cross checking on the worker's income tax return to ensure that the payments are included. Furthermore, even if the payment falls within the Form 1099 information reporting requirement, only nominal penalties are imposed on the employer who fails to report such payments.

I understand that staff has given you a copy of our 1995 report for inclusion in the hearing record. This report recommends a number of specific legislative and administrative steps to enact meaningful reform in this area. We believe, however, that any changes to reform the worker classification rules must go hand-in-hand with reform to improve compliance and reporting of income by self-employed workers.

Our report also reviews recent legislative approaches for reform in this area, including the Kim and Christensen Bills. We believe that the objective criteria for classification of a worker as an independent contractor under the Christensen/Kim/ Lantos bills could be so easily satisfied in the employer/worker relationship that there is a significant risk of undermining treatment of workers as employees, especially given the current cost incentives to employers to classify their workers as independent contractors.

Our report recommends the adoption of objective safe harbor tests to determine independent contractor status and employee status. In defining these safe harbors, we attempt to select the most important criteria for distinguishing independent contractors from employees. We recommend that a worker be classified as an independent contractor if (a) the worker could suffer a loss as well as make a profit in the performance of services; (b) the worker maintains a principal place of business separate from the employer's and has a significant investment in facilities and tools not typically maintained by employees; (c) the worker makes his services available to the general public and the worker has performed services for at least one other employer during the current year or the previous calendar year; and (d) the worker enters into a written qualified agreement with his employer that (i) specifies the services to be provided by the worker and the duration of the services, (ii) provides that the worker is aware of his employment tax obligations and will report and pay in accordance with independent contractor classification and (iii) requires the worker to maintain his or her own set of books and records with respect to the worker's business. If the worker satisfies all of the above criteria, he or she would be classified as an independent contractor.

As to the objective criteria that must be satisfied for classification of a worker as an employee, we recommend that such classification be required if the worker meets two or fewer of the objective criteria required for classification as an independent contractor and works for the employer for twenty hours or more per week. Workers not meeting either the independent contractor safe harbor or the objective tests for classification as an employee would be tested under the common-law rules. So that clearer guidelines can be developed for application of the common-law rule tests where necessary, we recommend that the current moratorium on Treasury Guidance imposed by Section 530 be removed.

The report also recommends modifications to the Section 530 safe harbor. Section 530 would be incorporated into the Internal Revenue Code so that the safe harbor would extend to income tax as well employment tax treatment. The codification of Section 530 will also permit Treasury and the Internal Revenue Service to issue needed guidance in the form of regulations and revenue rulings to implement this relief provision in the manner in which it was intended. We also recommend narrowing the application of the Section 530 safe harbor to limit the "prior audit" safe harbor to Internal Revenue Service audits which have examined the employment tax status of the employer's workers.

As additional relief to employers from retroactive assessments of employment taxes, we recommend the adoption of a new procedure that would allow an employer to file a supplemental Form 1099 which would have the effect of starting a three year statute of limitations period for the Internal Revenue Service to review the classification of that worker as an independent contractor. This procedure would be an alternative to the more cumbersome private letter ruling process and would be elective to the employer. The procedure would be used by employers who have a concern regarding whether they are correctly treating a worker as an independent contractor and do not wish to be open to assessments from IRS reclassification of the worker for the indefinite future.

The report recommends a number of reforms intended to improve compliance in reporting of income paid to independent contractors: (1) We recommend increasing the penalty for an employer's failure to file information returns to the greater of \$50 or 5% of the amount required to have been reported correctly but not so reported. We also recommend raising the cap on the penalty from its current \$250,000 level to a substantially higher amount. (2) We recommend lowering the \$600 reporting threshold for payments made to independent contractors in order to increase the payment information reported to the IRS on Forms 1099. Treasury would be directed to set appropriate reporting threshold levels for the type of services performed. (3) We recommend requiring information reporting on Form 1099 for payments made to workers who are incorporated. The present law exemption provides an easy avoidance mechanism to workers who do not wish to have Form 1099 reporting on their payments. (4) We recommend establishing a system whereby employers can make a quick TIN check through an IRS "800" number to verify the social security number given to them by a worker prior to making any payments to the worker. The current TIN verification system is so cumbersome that it often takes more than a year for the IRS to notify the employer that a TIN is invalid. This results in significant loss of revenue and inability of the Service to computer match the payment made by the employer to the worker's tax return. To discourage workers from deliberately falsifying TINs, we recommend that the TIN statements given to the employer be certified by the worker. (5) We recommend that businesses be required to segregate and separately report on their tax returns payments made to independent contractors just as now must be done for payments made to employees. A correlative change would require the worker to attach all Forms 1099 received to his or her income tax return just as Forms W-2 must be attached to an employee's return. We believe this will assist the IRS in computer matching of payments received by independent contractors.

We recommend requiring businesses to provide all workers who are treated as independent contractors with a written explanation of their tax obligations and rights as self-employed workers. The worker should be able to make an informed decision as to the overall benefits and costs of working for one employer versus another. A better understanding of the additional employment tax burdens and other costs (e.g. health insurance, life insurance) may improve the odds that the worker will set aside sufficient funds to pay income and employment taxes.

If the cost of requiring and allowing more magnetic-media filing of Forms 1099 is not too great in comparison to the benefit received, we recommend that the low-volume filer exception for magnetic-media filing of Forms 1099-MISC should be reduced or eliminated. This should give the IRS a greater ability to process and cross-check data.

We also recommend the creation of a new Form 1099-IC to be submitted by employers for payments made to independent contractors. The segregation of these payments from other miscellaneous payments will allow for better cross-checking by the IRS.

We recommend that a study be undertaken by Treasury analyzing the viability of imposing income and/or employment tax withholding on payments to independent contractors. Former studies have failed to come up with a flat rate withholding system that does not result in overwithholding to the worker.

Finally, we recommend that consideration be given to including an amnesty program as any part of legislation to increase the penalties on employers for failure to comply with Form 1099 information reporting on independent contractors.

The Tax Section urges the Committee to undertake drafting of legislation to enact the needed reforms of this area. We stand ready to assist in any way needed in this process.

Chairman JOHNSON. Thank you very much. I appreciate the specificity of your recommendations.

Mr. Shulman.

STATEMENT OF HARVEY J. SHULMAN, PARTNER, GINSBURG, FELDMAN AND BRESS, WASHINGTON, DC, AND GENERAL COUNSEL, NATIONAL ASSOCIATION OF COMPUTER CONSULTANT BUSINESSES

Mr. Shulman. Thank you, Madam Chairman.

My experience in dozens of IRS employment tax matters across the country leads me to give you the same simple message that many others have today. Namely, recent IRS actions cannot get us out of the current independent contractor mess. Instead, it has come time for Congress to bite the bullet and to do something on this issue.

Everyone here is throwing out the number "five." I have five sets of issues, also. I would suggest that you focus on the details in my

written testimony.

First, I do agree that a new statutory definition of independent contractor is essential, but this is because in my view the common law test will always be unclear and tilted against small business, and—a point that many people have not made—it is going to be outdated in this information age.

For example, self-employed proprietors and professionals often do not have the ability or the need to rent an office space, to pay for costly advertising, to buy computers devoted solely to business operations, or to serve many clients concurrently. These factors should not make these workers any less of an entrepreneur. Yet, the IRS has said otherwise under the outdated common law test.

In addition, the IRS has too often viewed many self-employed professionals as employees because the IRS has actually ignored the common sense rule in the Restatement of Agency Rule, it says that special skills and a high level of independence on the job are actually evidence of independent contractor status, not reasons to more closely suspect that an employment relationship exists, which

is the way the IRS tends to look at professionals.

These results can be even worse when the test is narrowly applied to new professional occupations, like computer programmers or software engineers. Therefore, I do have some disagreement with my colleagues on this "risk of loss" element. How many times can you say that a lawyer or an accountant or a computer professional has a "risk of loss?" We all know the rates that these people charge are outrageous to begin with. So, you do not have to work many hours to recover your expenses, but that shouldn't mean that these professionals are not considered self-employed entrepreneurs.

Second, I believe that Congress must improve section 530 of the

Revenue Act by adding language that the IRS cannot dilute.

The testimony you heard earlier talks about improving the consistency standard and what is a substantially similar position. But, no one has talked about that in detail. That is discussed in my written testimony in detail, the unreasonable evidentiary burden that is imposed on taxpayers, and what is a reasonable basis for classification.

Although many IRS positions on these issues have actually been rejected by the courts, the IRS continues to non-acquiesce in these decisions, and unless you do something about it legislatively, the Training Guide can be overturned a year from now by some other IRS Commissioner.

Third, I think there are two especially unfair laws beyond IRS control that Congress must fix now. First and foremost, you must repeal section 1706 of the 1986 Tax Reform Act. The repeal is supported by a strong bipartisan consensus in Congress and among tax professionals. It is even mentioned in the ABA testimony today, and throughout the business community. It is hard to believe, Madam Chairman, that in a high-tech economy, this irrational law prohibits certain taxpayers in the computer and engineering industries, no matter how reasonable their actions are, from submitting a section 530 Safe Haven Relief claim.

It is ironic to hear witnesses today complain about the common law test and to ask Congress to fix section 530 when many tax-payers in America's high-tech industries—the driving force of today's economy—are denied any eligibility whatsoever for section 530 relief and instead are left to defend themselves in IRS audits solely under the ancient common law test. How can we let this continue?

Before any other changes, Congress must close this gaping hole in the section 530 safety net by repealing 1706.

Likewise, Congress must change the tax assessment and judicial review procedures which now result in an automatic employment tax lien on a business even before the business has had its day in court. Once these liens are imposed, suppliers and banks stop doing business with a small business. This strangle-hold on small business that the lien imposes means the lien is the death sentence, and you never get to court no matter how right you are in classification.

Fourth, Congress must stop many of the investigative techniques used by the IRS in these audits. These have not been mentioned today, but how can we continue to let the IRS auditors interrogate third parties like a small business' clients and contractors, in order to get information on worker classification?

I can tell you I have seen how IRS contacts with customers and contractors terrifies these people and leads them to stop doing business with a firm under audit. Yet, these contacts are still sanctioned by the IRS manual.

Finally, Congress must act to increase compliance relating to the reporting of payments made to contractors, and it must impose greater penalties for failures to report payments or declare income.

In closing, Madam Chair, as we get ready to enter the 21st century, we must bring an end to the IRS regulatory framework which threatens self-initiative, entrepreneurship, and small business growth. Why should a computer programmer or a stockbroker or a doctor who wants to be self-employed be forced by our government to work as an employee?

I hope my testimony shows we can have both high tax compliance and greater flexibility. The Finance Committee in the Senate last week marked up the House-passed small business tax package, and it included some minor worker reclassification reforms. They should be congratulated, but please go further and help finish that job, including by repealing section 1706. Thank you.

[The prepared statement follows:]

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Before the Oversight Subcommittee of the Committee on Ways and Means U.S. House of Representatives

U.S. House of Representatives
Washington, D.C.
March 20, 1996

TESTIMONY OF HARVEY J. SHULMAN

PARTNER in GINSBURG, FELDMAN & BRESS, CHTD. (WASHINGTON, D.C.)
AND

NERAL COUNSEL of NATIONAL ASSOCIATION OF COMPUTER CONSULTANT BUSINESSES

INTRODUCTION. My name is Harvey Shulman. I am a partner in the Washington, D.C. law firm of isburg, Feldman & Bress, Chtd. and have been a lawyer for 24 years. I am also general counsel of the ational Association of Computer Consultant Businesses ("NACCB"), which is the largest national association at exclusively represents high-tech firms that provide computer and engineering professional consultants to astomers in need of temporary support for special projects. Along with my colleague Craig Etter, who helped repare this testimony, I have been involved in approximately 50 employment tax examinations and compliance thecks throughout the country in the past several years.

My message today is quite simple: Unfortunately, I have serious doubts that the new IRS Training Guide can really get us out of the independent contractor "mess" that now exists. It is said that a newly revised Training Guide makes major improvements from the draft that was released on February 28, 1996 — and obviously, practitioners and taxpayers will have to review the revised Guide and make a judgment if that is the case. But even if such improvements exist, it appears that at least four major faults will remain.

II. FUNDAMENTAL PROBLEMS IN EMPLOYMENT TAX EXAMS UNTOUCHED BY THE GUIDE

Eirst, despite the Training Guide, the interpretation and application of the common law factors seems destined to remain too ambiguous and particularly titled against small businesses like start-up sole proprietors and professionals in this information age. For example, rented office space, computers and office equipment solely dedicated to business operations, advertising, and multiple concurrent customers are all allegedly hallmarks of independent contractor status unifier the centuries-old common law test and are addressed in the Guide as "financial control" factors. Yet as the Guide occasionally suggests, 1990's economic realism demonstrates that many neophyte – but legitimate –sole proprietors often do not have the luxury to spend precious dollars on these items, nor does it make sense for them to do so especially when they are 'knowledge' workers whose investments are in their heads to be taken to on-site locations of their customers. Moreover, why should sole proprietors be asked to pursue multiple concurrent customers when many are striving – and delighted – to keep a single large customer happy. In addition, the fundamental factor of "behavioral control" has become more difficult to apply in this information age, as the Guide properly recognizes in its effort to distinguish 'suggestions' from "instructions' under the common law test. Even a perfect Training Guide is limited in its ability to apply a centuries-old common law test to occupations that did not exist 10 or 20 years

Second, too often the IRS's interpretation of Section 530 of the 1978 Revenue Act has remained at odds with the Congressional directive that this law be construed liberally in favor of taxpayers. For example, the IRS's position on the consistency standard as applied to workers in "substantially similar positions" is too cramped. Likewise, Section 530 is undermined when the IRS refuses to recognize that decisions by other federal or state agencies or courts that a worker is an independent contractor under other stantes. So too, the IRS has been unreasonable in issuing a "nonacquiescence" to court decisions which found that a taxpayer can have a "reasonable basis" under the common law for classifying workers. These examples show how Congressional benevolence has been transformed into bureaucratic severity.

Third, the IRS task of implementing the Guide in the field is enormous, is likely to take years, and does not remove the serious collateral harms that result during worker classification audits. As to implementing the Guide, not only must the "substance" of the IRS positions be communicated to IRS field personnel, but there must be a wholesale shift in attitude among those personnel. But more significantly, even if that training effort succeeds, taxpayers will consider the process to be a failure unless major changes are made in the procedures that IRS auditors use to conduct an audit and the procedures for making assessments. It should not be acceptable for IRS auditors to continue, as they do now during employment tax audits, to interrogate a small business's customers, clients, and independent contractors in order to get information to use in making a worker classification decision. I have personally seen how such IRS contacts by themselves often terrify those who do business with a firm under audit and cause many of them to avoid that firm. The firm may ultimately win its audit, but be out of business because of the IRS investigative techniques that are untouched by the Guide and still sanctioned by the IRS Manual.

Fourth, the Guide cannot by administrative fiar resolve problems that were clearly created by statute. For example, there is a strong bi-partisan consensus in Congress, supported by tax professionals and by the business community, that Congress must repeal Section 1706 of the 1986 Tax Reform Act. Nothing in the Guide can remove this irrational statutory provision that prohibits taxpayers in the computer and engineering industries — no matter how reasonable their actions may have been — from claiming Section 530 relief. In fact, the Guide specifically notes that even if, for example, the IRS agreed with an engineering firm that it has been a common, consistent and longstanding industry practice to treat engineers as independent contractors, Section 1706 prohibits recognition of this and every other reasonable basis. Likewise, the Guide cannot eliminate the unfair employment tax "assessment" process which is mandated by statute and which requires the IRS to impose a lien on a business for employment taxes even before the business has had its day in court before an unbiased judge.

III. ADDITIONAL STEPS REQUIRED BEYOND THE GUIDE

The conclusion with which I am left is that despite the Guide, we must replace the common law employment test with a simpler, shorter and more definitive classification test that takes the focus away from classification and places it on maintaining high levels of tax compliance: simply put, there should be greater initiatives to insure reporting and payment compliance, with increased penalties for failure to comply, and there should be far less focus on the complex classification issue. But we cannot stop there. We must improve an enhance Section 530 — including repeal Section 1706 (which is Section 530(d)) — provide taxpayers more procedural protections during employment tax audits, and stop the crazy tax assessment and lien process that undermines whatever other substantive standards and procedural rights we provide to taxpayers. We must take these steps so that self-initiative, entrepreneurship and small business growth — all of which suffer under the current IRS classification scheme — are no longer sacrificed as a price to pay for tax compliance. We gan have both high tax compliance and fewer restrictions on the ability of firms and workers to establish an independent contractor relationship. Several approaches are possible. Four steps are appropriate.

Eirst, H.R. 1972, introduced by Congressman Christensen, provides a simpler, shorter and more definitive classification test. In response to some criticism that H.R. 1972 may allow for too many workers to be treated as independent contractors, it must be remembered that to a large degree marketplace forces will eliminate any realistic probability that every worker will become an independent contractor. In addition, H.R. 1972 addresses only Internal Revenue Code issues: a worker who is an employee for purposes of wage and hour law, equal employment law, National Labor Relations Act purposes, OSHA and other laws will remain an employee under those laws. There are also reports that some Members of Congress are concerned that some low-paid classes of workers with little skills or education may be coerced by some firms into becoming independent contractors against their will, without reasonable opportunities to work as employees for other firms. These Members have suggested that Congress must create additional categories of "stantory employees" at the same time that it enacts H.R. 1972. However, it may be more prudent to wait a few years after the enactment of H.R. 1972 to determine if these predicted abuses have come to pass. Regardless, whether new "stantory employees" categories are enacted now or in the future, the bottom line is that H.R. 1972 provides a good foundation for simplifying the common law test.

Second, whether or not H.R. 1972 is enacted — and certainly if it is not enacted — Congress must clarify and enhance the rights afforded to taxpayers by Section 530. To begin with, Section 530 will remain like a cruise ship with a gaping hole in it until Section 1706 — which is subsection (d) of Section 530 — is repealed, and the computer and engineering industries are given the same rights as every other industry. In addition, my detailed testimony explains how Congress must direct the IRS to liberally apply several of the provisions in Section 530, including those relating to what is "inconsistent treatment" of workers holding "substantially similar positions", what constitutes a "longstanding recognized practice of a significant segment of an industry", what constitutes "any other reasonable basis", and which party has what burden under Section 530. In addition, Section 530 should be extended to cover income tax audits of the workers themselves.

Third, we must change the assessment process in employment tax audits, and the IRS investigative process used during the audits themselves. My detailed testimony includes suggestions on how Congress should make changes to the statutory assessment procedures (unless a taxpayer is found to have intentionally misclassified workers or to have withheld and not paid over taxes). Unlike income tax audits where no assessment can be made or lien can be filed until after a court trial before an unbiased judge, the internal Revenue Code requires the IRS to make an assessment, which becomes a lien, right after the IRS Appeals Office upholds a worker classification decision. This IRS assessment and lien action leads many financial institutions to cut off a small business taxpayer's line of credit. A court might ultimately rule in favor of the taxpayer in a refund suit in court, but many taxpayers never get that far because they will be forced out of business due to the pre-judicial assessment and lien. As to the IRS investigative procedures during audits of contacting a taxpayer's customers, clients and independent contractors, either the IRS should quickly amend it Manual to stop these actions or Congress should step in.

Fourth, and finally, Congress must take steps to require greater compliance related to the reporting of payments made to independent contractors, and to impose greater penalties for failures to report that are more than de minimis. A \$50 penalty for not issuing a 1099, at least where such failures are widespread, is too low; attachment of Forms 1099 to an independent contractor's income tax return, just like Forms W-2 must be attached to an employee's income tax return, should also be considered. Other improvements are also possible However, I would like to stress that none of these steps should be taken to impose greater burdens on small businesses and independent contractors <u>unless</u> they are accompanied by the type of relief set forth above.

*** *** *** ***

Thank you for the opportunity to testify. Below are details of some of the above topics.

ATTACHMENT TO TESTIMONY OF HARVEY J. SHULMAN

I. REVISION OF SECTION 530 SAFE HARBOR RELIEF PROVISIONS.

Until a new definition of employee or independent contractor is legislated, Section 530 represents the only back-up alternative to the unpredictable 20-question common law test. As such, a reasonable, understandable and non-discriminatory updated version of Section 530 is critical to protect small business.

A. Congress Should Repeal Section 1706 of the 1986 Tax Reform Act. A prerequisite to "improving" Section 530 is making it applicable to all taxpayers including those in so-called three-party arrangements in the textholical services industry. To "leave these taxpayers in the dust", while making Section 530 a better law for everyone else, is illogical and unjust. As a result of Section 1706 of the 1986 Tax Reform Act, Congress removed the Section 530 safe harbor for only the technical services industry, and it did so in a most insidious manner. In particular, it focused only on so-called "three-party" situations in the technical services industry in which a worker (the first party) uses the services of a broker (the second, or intermediate party) to locate consulting opportunities with a client or customer (the third party). Section 1706 took away all Section 530 relief from the intermediate party, the broker. In fact, customers who contract directly with consultants in so called "two-party" situations still have Section 530 relief; and, even in the "three-party" situations, the customers also retain Section 530 relief — only the broker has been targeted.

As a result of Section 1706, the technical services industry is the only industry in this country where the employment tax liabilities of certain firms are determined under only one test, the 20-factor common law employment test. In every other industry, — whether in "three-party" or "two-party" situations — eyery firm has its employment tax obligations determined under two alternative tests: either the 20-factor common law employment test of a back-up, alternative employment tax safe haven such as Section 530. If a worker is determined to be self-employed under either alternatives, then the worker — and not the firm — must pay the employment taxes. The denial of both alternatives to the technical services industry is clearly discriminatory and, for this reason, we urge repeal of Section 1706.

In order to understand the compelling reasons for repealing Section 1706, it is important to understand how that provision was enacted. Section 1706 originated as a non-controversial "revenue offset" measure that was estimated to raise \$12 million per year; it was never analyzed in detail and it was never discussed in any hearings. As a proposed "revenue offset" measure, it was also somewhat of an "experiment" in reaction to claims that the Section 530 safe haven was "too liberal" and had led to tax noncompliance which sometimes resulted in unfair competitive advantages to certain firms and workers — claims which, it should be noted, would apply to every industry if they are true.

Unfortunately, the "experiment" that became Section 1706 created a nightmare for the technical services industry by placing it in the very same vulnerable situation that all firms faced in the 1970s and that led in the first place to enactment of the Section 530 back-up, alternative employment tax safe haven. As a result, Congress received thousands of complaints that the Section 1706 "experiment" had failed, and in 1987 over 125 members of the House — including a bipartisan majority of the Ways and Means Committee — called for a two year moratorium on Section 1706 while it could be studied. The proposed moratorium was not pursued, but in 1988 Congress passed Section 6072 of TAMRA to require the Treasury Department to study the impact of Section 1706.

The Treasury Department Study, released in March 1991, is the most comprehensive and unbiased analysis of Section 1706. The Treasury Department Study contains new information, not available in 1986, which confirms that the discrimination against the technical services industry cannot be justified — and that legislative relief is necessary.

First, the Study concluded that although the technical services industry had been the <u>only</u> industry singled out for loss of the Section 530 back-up, alternative employment tax safe haven, that discrimination had been imposed against an industry in which there is actually <u>better tax compliance</u> in comparison to many other industries. When Congress enacted Section 1706, it did not know this fact!

<u>Second</u>, the Study found that especially because of its application to <u>only</u> so-called "three-party situations" in the technical services industry" — and the exemption of "two-party" situations — Section 1706 is "difficult to justify on equity or other policy grounds."

Third, the Study confirmed that application of the "20-factor common law [employment] test can be difficult, in particular in the multi-party situations affected by Section 1706" (emphasis added); indeed, the Study quoted an Assistant Treasury Secretary who admitted that this test "may also produce inappropriate results" and "does not yield clear, consistent, or satisfactory answers".

Fourth, the Study dispelled the notion that the government loses tax revenues when technical services workers perform services as independent contractors instead of as employees. The Study found that when workers in any industry perform services as independent contractors, some may underreport their incomes or overstate their business expenses. But the Study concluded that for the technical services industry, "Misclassification of employees as independent contractors increases tax revenues, however, and tends to offset the revenue loss from undercompliance by individuals, because direct [taxable cash] compensation to independent contractors is substituted for tax-favored employee fringe benefits."

In short, after the Treasury Study, there is no longer any justification for continuing the tax discrimination created by Section 1706. If the technical services industry is to be denied all Section 530 relief, then so must every other industry; if 'three-party' relationships in our industry are to be denied Section 530 protection, then so must "two-party" situations — and no one is proposing those drastic elematives. Nor can it be said that classification of workers as independent contractors actually results in revenue losses. Finally, after the Lambert's Nursery decision, it is untrue that firms which have used both employees and independent contractors cannot compete on a "level playing field" with firms that use only independent contractors on the assumption that the IRS will deny Section 530 relief to the former firms while granting Section 530 relief to the latter firms, it is the relationship with each group of workers that counts, not whether the workers are performing similar services.

Enough has been said and studied on this issue. Now is the time to repeal Section 1706.

B. Congress Should Define the Term "Substantially Similar Position". To qualify for relief, Section 530 requires the taxpayer to have consistently treated the workers at issue — and all workers holding "substantially similar position"—as independent contractors. Although Section 530 itself does not define the term "substantially similar position", the IRS interpretation of the term has not been in accordance with original Congressional intent and the IRS interpretation has, in fact, been rightfully rejected by the judiciary. Without clear guidance from Congress as to what is a "substantially similar position", the IRS interpretation of this term will continue to be confusing at best, and erroneous at worst, and yet it will be asserted against taxpayers who will then be forced to litigate with the IRS over that interpretation. The details of our proposal follow.

Prior to the draft Training Guide, the most recent "official" IRS position on this issue was set forth in Rev. Rul. 87-41. In that ruling the IRS stated that a determination of whether an individual whom the istreated an employee 'holds a position substantially similar to the position held by an individual whom the taxpayer would otherwise be permitted to treat as other than an employee for employment tax purposes under section 530(a) of the 1978 Act requires an examination of all the facts and circumstances, including particularly the activities and functions performed by the individuals. "While it is true that "all the facts and circumstances" must be reviewed, there is nothing in Section 530 which focuses the inquiry "particularly" on the "activities and functions" performed by a worker. Even more troubling is the IRS statement from Rev. Rul. 87-41 which follows the above quoted sentence:

<u>Differences</u> in positions held by the respective individuals that result from the taxpayer's treatment of one individual as an employee and the other individual as other than an employee (for example, that the former individual is a participant in the taxpayer's qualified pension plan or health plan and the latter is not a participant in either) are to be disregarded in determining whether the individuals hold substantially similar positions. (emphasis added).

The draft Training Guide issued in February 1996 held out some hope that the IRS might back away from the above erroneous interpretation. On page 3-10, the draft Guide stated:

A substantially similar position exists if the job functions, duties, and responsibilities are substantially similar and the control and supervision of those duties and supervision is substantially similar. (emphasis added).

Rightly so, therefore, the draft Guide looked at how the firm controlled and supervised a worker. Unfortunately, however, elsewhere the draft Guide fell back into the same improper interpretation that was set forth in Rev. Rul. 87-41. Namely, on page 3-12 the draft Guide noted that "Comparison of job functions is on important factor" in determining if positions are "substantially similar"; it failed to refer to the need to compare how or if the firm controlled and supervised workers with similar job functions and, instead, even told auditors not to consider such factors as whether a worker "punches a time clock, receives company benefits, or is covered by workers' compensation". Then, in Example 4 on page 3-13, the draft Guide concluded that there was inconsistent treatment of workers in "substantially similar positions" based on the facts that workers were "all doing the same job" or that they "performed substantially the same job". The language on page 3-12 and the example on page 3-13 undernime the positive statement on page 3-10 that much, more than "doing the same job" is involved in determining if workers hold "substantially similar positions".

The IRS's narrow emphasis in Rev. Rul. 87-41 on the "activities and functions" performed by a worker, and its own seemingly inconsistent discussion in the draft Guide of the differences in a taxpayer's treatment of workers, do not comport with the letter and spirit of Section 530, nor with the common sense operations of businesses that used both independent contractors and employees prior to the passage of Section 530.

Congress required from the outset that the reasonable basis requirement of Section 530 "be construed liberally in favor of taxpayers." House Ways & Means Committee Report No. 95-1748 at p. 5 (Oct. 10, 1978). See. e.g., American Institute of Family Relations v. U.S., 79-1 USTC 19364 (C.D. Cal. 1979)(court reached proper result by broad interpretation of Section 530); Critical Care Register Nursing. Inc. v. United States, 776 F.Supp. 1025 (E.D. Pa. 1991)(court reached proper result by broad interpretation of Section 530). Indeed, Congress stated that the "consistency" standard was an "anti-abuse provision" that was intended "to prevent taxpayers from changing the way they treat workers for employment tax purposes solely to take advantage of the relief provisions...." [d. at p. 5. The IRS's reading of the "consistency" standard in Rev. Rul. 87-41 is inconsistent with Congressional intent that Section 530 "be construed liberally".

In many typical situations, a worker who is treated as an independent contractor may perform some of the same or similar "activities and functions" as a worker who is treated as an employee; the fact that their "activities and functions" are similar does not mean that these two workers hold "substantially similar positions" with a taxpayer. Similarly, workers who perform very different "activities and functions" might well hold "substantially similar positions" with a taxpayer. What is of major importance is not be duties themselves, but instead that taxpayer's treatment of the workers, i.e., the relationships between the workers and the taxpayer. Even before Section 530 was enacted, the overwhelming body of judicial precedent recognized that both independent contractors and employees could be performing the very same work for a single service recipient, and that their different relationships with the service recipient – not the nature of their work – would determine their employment status. See, e.g., Radio, City Music Hall v, United States, 135 F.2d 715 (2d Cir. 1943)(theater owner provided entertainment to its audiences through the use of its own in-house musicians, dancers and actors who were its employees as well as by hiring independent contractors); United States, 17-10 Total Circ Intercept of the states of its own contractors to install roofing and siding, but if it could not find acceptable independent contractors at an acceptable rate, it would use its own employees to do the installations); Anaca, Inc. v, United States, 77-1 USTC ¶ 9139 (D. M. M. 1976)(moving company hired its own employees to assist drivers in the packing, loading and unloading of moving vans, and also hired independent contractors to perform the same exact work in those instances where the company's own employees were not available). Because Section 530 is to be "liberally construed in favor taxpayers", it makes no sense that a taxpayer can under the more restrictive common law test properly treat some workers as independent contra

In short, when Congress first enacted Section 530, it knew that workers did not hold "substantially similar positions" just because they performed similar types of work. For the IRS to interpret this term in the manner set forth in Rev. Rul. 87-41 is inconsistent with prior case law and the common sense, as well as the charitable reading of Section 530 intended by Congress.

The correct approach to interpreting Section 530 was set forth in the decision of the U.S. Court of Appeals for the Fifth Circuit in Lambert's Nursery & Landscaping. Inc. v U.S., 894 F.2a 154 (5th Cir. 1990) - a case which the IRS did not even cire in the draft Guide. In the Lambert's Nursery set, the taxpayer started his business in Louisiana by using independent contractors to do landscaping for customers. An IRS employment tax audit upheld his classification of the landscape workers. He later expanded his business to provide janitorial services to customers by using independent contractors. In addition to these independent contractors, the taxpayer also employed some landscape and janitorial workers as his employees, though he treated them differently. When the IRS audited his business because of his classification of the janitorial workers as independent contractors, the taxpayer claimed the "prior audit" safe haven under Section 530(a)(2)(B). The IRS denied his claim, noting that the janitorial workers did not hold "positions substantially similar to the position[s] held by "the landscape workers. The Court rejected the IRS view and commented on the reference to "substantially similar position" in Section 530:

The IRS ... has provided no authority to support its assertion that the type of work done, rather than the structure of the relationship between the taxpayer and his workers, should be the preeminent interpretive factor for section 530(a)(2)(B). Neither does the plain wording of the provision provide support for the IRS position. The "reasonable basis" requirement of section 530(a)(1) to which section 530(a)(2)(B) is directly linked, has been broadly interpreted in favor of taxpayers. General Investment Corp. v United States, 823 F.2d 337, 340 (9th Cir. 1987). The relationship of the taxpayer to his workers is the most important element of the section 530(a)(2)(B) analysis, and a taxpayer may reasonably rely on a prior [employment tax] audit pursuant to a section 530(a)(2)(B) even though he later employs substantially similar workers in a different industry.

The Lambert's Nursery court reached the correct result because, in interpreting the words "substantially similar position", it looked primarily at the worker's service relationship with the taxpayer and not at the worker's job duties. See also REAG. Inc. v. United States, 92-2 USTC ¶ 50.475 (W.D. Okl. 1992)(Court rejected the IRS's argument that REAG inconsistently treated its non-owner appraisers as independent contractors and its owner-officer appraisers as employees because the relationship between the taxpayer and the owner-officer appraisers was different — i.e., involving management control and substantial additional duties -than the relationship between the taxpayer and the non-owner appraisers); Reinhardt v. Commissioner, 85 T.C.
511, 522 n. 16 (1985)(Tax Court emphasized with approval the fact that the IRS has issued a letter to the taxpayer/doctor in which the IRS granted Section 530 relief where a clinic had continuously treated its shareholder doctors as employees and its non-shareholder doctors as independent contractors even though both groups of doctors perform the very same type of services.).

For example, suppose there are three workers: the first worker is an accountant, the second worker is a lawyer, and the third worker is also an accountant. The first worker is treated as an employee of the taxpayer, i.e., the taxpayer withholds and pays over taxes, under a relationship that includes the following: the worker is legally guaranteed to be paid by the taxpayer for the time worked, even if the quality of the work is unsatisfactory; the worker may be reassigned by the taxpayer to perform other work or to work in other locations; the worker is subject to review and promotion in accordance with the taxpayer's general staff policies; the worker is eligible to receive paid training from the taxpayer; the worker may not perform the same type of work for others without the taxpayer's permission; and the worker can resign at will, even in the middle of a project.

Even though the second worker may perform a totally dissimilar job $-\underline{e},\underline{e},\underline{e}$, the lawyer $-\underline{e}$ under the rationale of Lambert's Nursery he or she would hold a "substantially similar position" to the first worker if the above factors applied to both because the structure of the relationship between the lawyer and the taxpayer was the same as the structure of the relationship between the accountant and the taxpayer. Likewise, under this same rationale, even though the third worker performed the same type of job as the first worker $-\underline{e},\underline{e},\underline{e}$, both were accountants and excountants bould not hold "substantially similar positions" if the above factors applied only to the first worker and not the third worker. In short, the taxpayer would not lose the safe haven on the ground that the two accountants performed similar services because the structures of their relationships to the taxpayer were not substantially similar.

In conclusion, it is essential that Congress affirm the rationale of <u>Lambert's Nursery</u> and the pre-Section 530 common law cases, and reject the IRS position in Rev. Rul. 87-41 and the draft Guide.

- C. Congress Should Clarify What Constitutes a "Reasonable Basis". To qualify for relief under some taxpayer must demonstrate that it had a "reasonable basis" for treating the workers as independent contractors. Although the Congressional mandate has consistently been to contruct the reasonable basis requirement "liberally in favor of taxpayers", the IRS response has been simply to pay "lip service" to this admonition. See Rev. Proc. 85-18, 1985-1 C.B. 518; In practice, the IRS generally advances a very restrictive interpretation of the reasonable basis requirement.
- 1. Revision of "Judicial Precedent" Safe Harbor. Under Section 530, reliance on "judicial precedent" will constitute a reasonable basis for treating the worker as an independent contractor. Despite the Congressional mandate of liberal construction, the IRS recently has applied a very restrictive

Interestingly, in the draft Guide at page 3-13 the IRS noted that it has nonacquiesced in the <u>REAG</u> decision; it cited, without explaining its view, two other conflicting decisions on this issue, i.e., <u>World Mart.</u> (E. D. Pa. 1992); and it also referenced the decision in <u>Lowen Corp.</u>, v. <u>United States</u>, 785 F. Supp. 913 (D. Kan. 1992). <u>Lowen</u> and other cases not cited, but which found inconsistency, are unexceptional in that they determined that purported distinctions in how taxpayers treated their workers were insignificant. <u>Moreover</u>, a "liberal" interpretation of the consistency standard should likely have led to a different result in <u>Lowen</u>.

position on what constitutes judicial precedent, requiring nearly identical facts before a taxpayer can rely on this safe harbor. See TAM 9443002. The taxpayer should be able to rely on judicial precedent which is generally similar to the facts in the taxpayer's situation.

2. Revision of "Prior Audit" Safe Harbor. The term "audit" is not defined in Section 530. The IRS has narrowly construed what it means by the term "audit". Indeed, the IRS often has — without opening a formal employment tax "audit" — actually engaged in an examination of a taxpayer's use of independent contractors to avoid the prior audit safe haven.

For example, many corporate <u>income</u> tax audits now include an IRS inquiry into a taxpayer's treatment of workers as independent contractors and the reasons for such treatment; they also result in IRS review of independent contractor agreements and other documents which relate to the workers' status — all of this being done as part of an <u>income</u> tax audit. Only sometimes is a separate formal <u>employment</u> tax audit opened in addition to the income tax audit; in fact, if no formal employment tax audit is opened, the IRS will not issue a written statement to the taxpayer that it correctly classified the contractors.

In many other cases, even when no income tax audit is pending, the IRS will contact a taxpayer and conduct an employment tax "compliance check" where similar detailed information about worker classification is sought from the taxpayer through interviews or examination of some taxpayer books and records (e.g., contracts and invoices). If the IRS thinks that the information it develops in a "compliance check" will not lead to worker reclassification, then it goes away — without issuing any formal written statements to a taxpayer that no problems were found. Of course, if the IRS believes that worker reclassification is necessary, then it will open a formal employment tax audit.

In both of these types of cases — as some IRS officials have admitted to us — the IRS is intentionally attempting to avoid opening a formal employment tax "audit" so that in the future the taxpayer cannot claim Section 530 relief, even if IRS has required the taxpayer to justify its treatment of independent contractors and even if the taxpayer successfully did so.

For these reasons, we believe that changes should be made to the existing Section 530 "prior audit" safe haven to prevent the IRS circumvention of this safe harbor. The term "audit" should include any IRS written or oral examination of the taxpayer, or review of the taxpayer's books and records, regarding the bases for the taxpayer's treatment of workers as independent contractors. It is not necessary that the IRS shall have opened a formal employment tax audit as long as, through questioning of the taxpayer or review of its books and records, the IRS has required the taxpayer to justify its treatment of workers as other than employees.

3. Definition of "Long-Standing Recognized Practice of a Significant Segment of the Industry". As with the definition of "substantially similar position" and the other stanutory safe harbors, the IRS has interpreted the reference to "industry practice" in Section 530 in a manner inconsistent with Congressional intent. The IRS approach focuses on four main issues: (i) within what geographic area must the industry practice occur? (ii) what is a "significant" segment of the industry? (iii) when is a recognized practice 'long-standing'? and (iv) what type of proof must the taxpayer produce to meet this safe harbor? Any legislative changes in Section 530 should include the following principles.

First, taxpayers should have the opportunity to demonstrate that an industry practice exists locally, within a state, regionally within a multi-state area, or even nationally. Taxpayers should be permitted to rely on any one or more of these geographic areas. The changes in the IRS position on this issue demonstrate why Congressional clarification is essential. At one point the IRS argued that taxpayers had to demonstrate a national practice, but this view was rejected by a major court decision. Geograf Investment Corp. v. United States, 823 F.2d 337 (9th Cir. 1987)(taxpayer can rely upon "industry practice" in the single county in which it operates, and IRS may not require evidence of nationwide practice). Now, the IRS Manual requires the taxpayer to produce evidence of entities in its industry "for the locality (the locality may operate for which the taxpayer must produce evidence is inconsistent with a "liberal" interpretation of Section 530. For example, although taxpayers in a particular locality may operate in one manner, the taxpayer under audit may have based its different method of operation on an "industry practice" that exists in the entire state or in that region of the country, or even on a practice that exists only in rural areas of the nation or in "big city" areas which it was trying to emulate — or on some combination of these areas. In short, as long as taxpayers have a reasonable explanation for the geographic area or areas on which they are relying, they should be permitted to demonstrate an "industry practice" in those areas.

Second, many IRS auditors will not recognize a practice as "significant" unless more than 50% of the firms in an area follow the same practice. This IRS position is an unduly cramped view of Section 530, and it finds no support in the legislative history or in case law. Indeed, nowhere in the legislative history did Congress indicate an intention to quantify "significant" as more than 50%. Moreover, significant court cases which have addressed the issue have relied on percentages well below 50%. See, e.g., REAG. Inc. v. United States, 92-2 USTC ¶ 50,475 (W.D. Okt. 1992)(Court relied on an industry survey in which only 24% of the relevant market responded and, of that 24%, three-fourths of the respondents stated that yet rested non-owner appraisers as independent contractors). In fact, the standard dictionary does not quantify the term as more than 50% either; rather, it defines "significant" as "meaningful" or "an observed departure from a hypothesis too large to be reasonably attributed to chance." See, e.g., Webster's New World Dictionary, Second College Edition. The reference to a "significant" segment of the industry means only that the practice be "meaningful"; to the extent that it is necessary to quantify this term, it should be sufficient for a taxpayer to provide reasonable evidence that at least 20% of the affected firms or workers engage in similar practices, unless the taxpayer can demonstrate why a lesser percentage is "significant".

Third, the issue sometimes arises as to what constitutes a "long-standing" practice. Currently, there is little guidance as to what constitutes a "long-standing" practice. The IRS views an industry practice of using independent contractors since 1978 as "long-standing" but suggests that this safe harbor may still be available to businesses that began after 1978. See draft Training Guide. Not surprisingly, the IRS has held that a company which starts a new industry cannot qualify for this safe harbor because there was no industry practice on which it could rely at the time it began business. See TAM 9420002. In this regard, Section 530 should be clarified to define "long-standing" as not limited to industry practices in existence prior to 1978 or to new

industries that developed after that date. Indeed, as new industries have developed, newly-formed practices should be considered "long-standing" after a period of years. For example, when Section 530 was enacted in 1978, the cellular telephone industry had not been developed. But if, several years after its development, a significant segment of the industry uses the services of independent contractors in various sales or technical services capacities, then such practices should be recognized as "long-standing" for purposes of Section 530 reclief. Congress did not intend a static view of the types of independent contractors that could or should be recognized.

Fourth, the IRS requires an incorrect level of proof for taxpayers to rely upon the industry practice safe haven. Currently, the IRS requires that the taxpayers identify specific competitors which also use the services of independent contractors and the details about the use and operations of these competitors. See IRS Manual - Administration 5(10)26.4(1)(c). In fact, taxpayers have often complained that even when a taxpayer provides a survey taken by an industry association of the use of independent contractors, the IRS has refused to accept that survey unless the names of firms which also use this class of workers are revealed. Yes, IRS examiners have candidly admitted to many taxpayers that this new list of firms provides a basis for additional audits of those firms. In other words, the industry practice safe haven will be implemented by the So only if a taxpayer under audit is willing to "snitch" on its competitors. Justifiably, the courts have not required the degree of General Investment Corp. v. United States, the taxpayer's evidence of industry practice consisted of testimony by the taxpayer's president and by one competitor, both of whom "had extensive familiarity with the operations of a number of other [competitors] through their roles as officers of a county-wide trade association", which involved "meetings with other mine owners and numerous visits to other mines." See also In re Billie Vester Rasbury, 91-USTC ¶ 50.454 (Bankr. N.D. Ala. 1991)(without the aid of any industry survey, the court concluded that there was a widespread industry practice of using independent contractors in the logging industry based on the first-hand knowledge in the testimony of Rasbury, long-time employees, and experts); In rs loev L. Benity, 1994 Bankr. LEXIS 261 (E.D. Tenn. 1994)(the court relied on the experiences and first-hand knowledge of the debtor and the company's bookkeeper to establish the debtor's reasonable reliance on industry practice). These cases properly apply Section 530; the type of evidence offered i

4. Clarify "Other Reasonable Basis" Safe Harbor. Despite the expansive language of Section 530 and the mandate of a liberal construction in favor of taxpayers, the IRS has been very reluctant — even in view of contrary case law — to expand the scope of qualifying "reasonable basis" standards beyond three specifically identified in Section 530 (i.e., judicial and IRS rulings, prior audits, and industry practice). Section 530 should be clarified to specifically include several additional reasonable basis as follows.

There are a number of cases which conclude that a taxpayer's reliance on the advice of tax professionals constitutes a reasonable basis under Section 530. See, e.g., Smokey Mountain Secrets. Inc. v. United States, 76 AFTR2d ¶ 955509 (E.D. Tenn. 1995).

There also are several cases holding that a taxpayer had a reasonable basis for treating workers as independent contractors based on a reasonable belief that the workers were independent contractors under the common law test. See, e.g., Critical Care Register Nursing, Inc. v. United States, 776 F. Supp. 1025 (E.D. Pa. 1991); REAG, Inc. v. United States, 92-2 USTC 450,475 (W.D. Okl. 1992).

Other cases have concluded that reliance on determinations by state agencies as to the classification of the workers as independent contractors also may constitute a reasonable basis for treating the workers as independent contractors. See, e.g., Overeen, V. United States, 91-2 USTC par. 50,459 (W.D. Okla. 1991)(decision by Oklahoma Employment Security Commission that workers were independent contractors might justify Section 530 relief if additional facts about state agency decision are provided); Ouensgate Dental Family Practice, Inc. v. United States, 91-2 USTC par. 50,536 (M.D. Pa. 1991)(state dental board statement that dentists must be treated as independent contractors provides reasonable basis under Section 530). See also Sanderson III v. United States, 862 F. Supp. 196 (N.D. Ohio 1994)(reliance on state worker's compensation audit).

In addition, the IRS interprets the "judicial precedent" safe harbor as not applying to precedent (rendered on facts similar to those of the taxpayer's situation) that was decided after the years under sudit. Even if this is a correct interpretation of Section 530, Congress should clarify that such precedent can, however, be relied upon by the taxpayer as an "other reasonable basis" for treating the workers as independent contractors (i.e., subsequent judicial confirmation that the taxpayer's classification of the workers as independent contractors was reasonable).

In sum, if the Congressional mandate of liberal construction is to become meaningful at the IRS administrative level, Congress should affirmatively clarify that a taxpayer is permitted to rely on any of the above as well as any other reasonable basis for purposes of qualifying for Section 530 relief.

D. Congress Should Clarify the Burden of Proof Under Section 530.

There is currently a dispute over whether a taxpayer has the same burden under Section 530 as exists otherwise in employment tax audits. Some cases, like <u>REAG_Inc. v. United States</u>, 801 F. Supp. 494 (W. D. Okla. 1992), explain that a taxpayer need only demonstrate that it has a substantial rational basis for its classification of workers as independent contractors under Section 530. However, in <u>Boles Trucking, Inc. v. United States</u>, 77 F.2d 236 (8th Cir. 1996), the court rejected the <u>REAG</u> analysis of burden of proof;

¹⁷ The draft Training Guide limits the "judicial precedent" safe harbor to reliance on federal court decisions. Even if that is the correct interpretation of the term "judicial precedent", Congress should clarify that state or federal court or agency decisions, particularly those that have applied the more restrictive "ABC" independent contractor test or the even more narrow "economic reality" independent contractor test (as in the FLSA), can at least be relied upon by a taxpayer as an "other reasonable basis" under Section 530 for classifying workers as independent contractors.

nonetheless, the court also confused the issue by stating that under Section 530 the taxpayer had the burden to prove by a preponderance of the evidence that it had a rational basis for improperly classifying the workers (italics in original, emphasis added), a standard that does not seem that different from RAG. A middle ground was suggested in McClellan v. United States, 900 F. Supp. 101 (E.D. Mich. 1995), where the court found that under Section 530 a taxpayer need only "come forward with an explanation and enough evidence to establish prima facie grounds for a finding of reasonableness....[T]his threshold burden is relatively low, and can be met with any reasonable showing. Once the taxpayer has made this prima facie showing, the burden then shifts to the IRS to verify or refute the taxpayer's explanation."

Congress should not 'eave taxpayers dangling over what is the correct burden of proof under Section 530. We suggest that Congress adopt the McCleilan standard and, as importantly, that Congress clarify that the IRS must show not only "unreasonableness" after a taxpayer makes a prima facie case, but also that the IRS must show "inconsistent" treatment of workers in "substantially similar positions". Particularly as to the latter, it is almost impossible for a taxpayer to introduce evidence of the positions of every worker it has ever treated as an employee and to show that such positions were not "substantially similar" to those of workers who were treated as independent contractors. Instead, if the IRS has evidence of "inconsistency", it should come forward with it and prove it affirmatively, rather than having the taxpayer effectively prove a "negative".

II. REVISION OF EMPLOYMENT TAX ASSESSMENT PROCEDURES

One of the most unfair aspects of the current employment tax system is how assessments are handled. In the following pages we offer statutory language for a proposal to eliminate assessments in employment tax exams involving worker misclassifications until after the taxpayer has had a chance to take its case to court and has lost in court. This new procedure — modeled almost entirely on how income, estate and gift, and excise taxes are handled — would provide for a "notice of employment tax deficiency" in lieu of an assessment. However, this new procedure would not be available if the taxpayer either misclassified its workers through intentional disregard of the law (which is the standard for denying the taxpayer a reduced assessment under § 3509(c)) or withheld the taxes from the workers but did not pay them over to the IRS. Also, the new procedure is intended to give taxpayers greater rights against taxpayers.

A. <u>Current Law is Unfair</u>. Under current law, IRS examiners or auditors "recommend" an employment tax assessment in IC misclassification cases. The taxpayer can then appeal to the IRS Appeals Office. If the Appeals Office agrees that the taxpayer has misclassified, and owes employment taxes, it demands payment from the taxpayer. If the taxpayer refuses to pay and wants to appeal further, by law under the IRC the tax that is due is immediately assessed and becomes a lien on the taxpayer. Typically, the IRS then files a notice of lien and begins to collect the assessed taxes. However, even if the IRS does not take any action beyond making the mere assessment, banks and other lenders will usually stop making loans to the taxpayer because the assessment itself is an automatic lien.

After an employment tax assessment under current law, the taxpayer must pay the tax on 1 worker for 1 quarter, then file a refund claim, and then generally wait 6 months for IRS action. If the IRS denies the refund claim, or fails to act, the taxpayer may sue for a refund in district court or in the Court of Federal Claims. At that point, the IRS will counter-claim for assessed taxes based on to the other misclassified workers.

B. Concrete Should Enact Changes to Current Law Assessment Procedures. Under the new proposal that is attached, when a taxpayer's misclassification of workers is not due to intentional disregard of the law or the taxpayer did not withhold taxes and then fail to pay them over to the IRS, the IRS would have to do what it does in all other types of tax cases — i.e., the IRS would have to issue a notice of tax deficiency (we've called it a notice of employment tax deficiency). If the IRS was in danger of losing the ability to collect because, for example, the taxpayer was siphoning funds from its accounts, the IRS still could — as it can with regard to other taxes — make a jeopardy assessment. After a notice of employment tax deficiency is issued, the taxpayer will have the opportunity to sue in the district court or the Court of Federal Claims, as is now the case (however, employment tax suits could not be brought in the Tax Court, where all other deficiencies are adjudicated). Only after the court issues a final decision would the IRS be able to make an assessment.

The following are proposed amendments to Chapter 63 of Sublific F to permit a tempayer to centest in the U.S. District Court or Claims Court certain proposed employment text deficiencies prior to assessment:

- Section 6201(d) of Chapter 63 shall be amended to add the following:
- "For special rules applicable to deficiencies of certain employment taxes, see subchapter B."
- The following subchapter shall be added to Chapter 63:

"SUBCHAPTER E. DEPICIENCY PROCEDURES IN THE CASE OF CERTAIN EMPLOYMENT TAXES

SEC. 6251. DEFINITION OF A EMPLOYMENT TAX DEFICIENCY.

- (a) In General. For purposes of this title in the case of employment taxes imposed by chapters 21 through 25 of subtitle C with respect to any worker by reason of treating such worker as not being an employee for purposes of such chapters, the tender of the subtitle C exceeds the stores of—
 "employment tax deficiency" means the enrount by which the taxes imposed by chapters 21 through 25 of subtitle C exceeds the stores of—
 - (1) the sum of
 - (A) the amount shown as the tax by the taxpayer upon his return, if the return was made by the taxpayer and an amount was shown as the tax by the taxpayer thereon, plus
 - (B) the amounts previously assessed (or collected without assessment) under chapters 21 through 25 of Subtitle C_1 over \rightarrow
 - (2) the amount of rebates, as defined in subsection (b)(i), made.
 - (b) Rules For Application of Subsection (a). For purposes of this section -

- (1) For purposes of this section, the term "rebets" meses so much of an ebstement, could, refund, or other payment, so was made on the ground that the taxes imposed by chapters 21 through 25 of subtitle C were less than the excess of the amount specified in subsection (a)(1) over the rebetse previously made:
- (2) Section Not To Apply in Cases of Intentional Disregard. This section shall not apply to a determination of the taxpayer's liability for tax under chapters 21 through 25 of subtitle C if such liability is due to the taxpayer's intentional disregard of the requirement to deduct and withhold such tax or the taxpayer has withhald and failed to pay over such tax.

SEC. 6252. NOTICE OF EMPLOYMENT TAX DEFICIENCY.

- (a) In General. If the Secretary determines that there is an employment tax deficiency concerning any taxes imposed by chapters 21 through 25 of subtitle C with respect to any worker by reason of treating such worker as not being an employee for purposes of such chapters, the Secretary is authorized to send notice of such employment tax deficiency to the taxpeyer by certified mail or registered mail.
- (b) Address For Notice Of Employment Tax Deficiency. In the absence of notice to the Secretary under section 6903 of the existence of a fiduciary relationship, notice of an employment tax deficiency in respect of taxes imposed by obspites 21 through 25 of arbitile C; finalized to the taxpeyer at his last known address, shall be sufficient for purposes of chapters 21 through 25 of subtile C, and this chapter even if such taxpeyer is deceased, or is under a legal disability, or, in the case of a corporation, has terminated its
- (c) Further Deficiency Letters Restricted. If the Secretary has mailed to the taxpeyer a notice of employment tax deficiency as provided in subsection (a), and the taxpeyer files a complaint in the U.S. District Court or the Claims Court within the time prescribed in section 6253(4) the Secretary shall have no right to determine any editional employment tax members are taxable year with respect to the taxpeyer's treatment of a worker as not being an employee, except for fraud, and except as provided in section 6562 (relating to the making of jeoparty assessments).
- (d) Authority To Rescind Notice Of Employment Tax Deficiency. The Secretary may, with the consect of the taxpeyer, rescind any notice of employment tax deficiency mailed to the taxpeyer. Any notice so rescinded shall not be treated as a notice of employment tax deficiency for purposes of subsection (e) (relating to further deficiency letters restricted), section 6253(a) (relating to restrictions applicable to deficiencies; complaints in U.S. District Court and Claims Court), and section 6512(o) (relating to limitations in case of complaints filled in U.S. District Court of Claims), and the taxpeyer shall have no right to file a complaint with the U.S. District Court ro Claims (out the deficiency) of the rescinded notice. Nothing in this subsection shall affect any suspension of the running of any period of limitations during any period during which the rescinded notice was outstanding.
- SEC. 6253. RESTRICTIONS APPLICABLE TO CERTAIN EMPLOYMENT TAX DEFICIENCIES; COMPLAINTS FILED IN U.S. DISTRICT COURT OR CLAIMS COURT.
- (a) Time For Filing Complaint Restriction On Assessment. Within 90 days, or 150 days if the notice of employment tax deficiency is addressed to a person outside the United States, after the notice of employment tax deficiency authorized in section 6252 is mailed (not counting States), after the property of the states of
 - (b) Exceptions To Restrictions On Assessment. -
 - (1) Intentional Disregard. If a determination of the taxpayer's liability for tax under chapters 21 through 25 of subtitle C is based on the taxpayer's intentional disregard of the requirement to deduct and withhold such tax or on the taxpayer's withholding but failure to pay over such tax, such underpaymore's shall be assessed.
 - (2) Assessment Of Amount Paid. Any amount paid as a tax or in respect of a tax may be assessed upon the receipt of such payment notwithstanding the provisions of subsection (a). In say case where such amount is paid after the mailing of the notice of employment tax deficiency under section 6252, such payment shall not deprive the U.S. District Court or the Claims Court of jurisdiction over such deficiency determined under section 6251 without regard to such assessment.
- (e) Pailure To File Complaint. If a taxpeyer does not file a complaint with the U.S. District Court or the Claims Court within the time prescribed in subsection (a), the employment tax deficiency, notice of which has been mailed to the taxpeyer, shall be assessed, and shall be paid upon notice and demand from the Sacretary.
- (d) Waiver Of Restrictions. The taxpayer shall at any time (whether or not a notice of employment tax deficiency has been issued) have the right, by a signed notice in writing filed with the Secretary, to waive the restrictions provided in subsection (a) on the assessment and collection of the whole or any part of the employment tax deficiency.
 - (e) Coordination With Title 11. --
 - (1) Suspension Of Running Of Period For Filing Complaint In Title 11 Cases. In any case under title 11 of the United States Code, the running of the time prescribed by subsection (a) for filing a complaint in the U.S. District Court or the Claims Court with respect to any employment tax deficiency shall be suspensed for the period during which the debtor is prohibited by reason of such case from filing a complaint in the U.S. District Court or the Claims Court with respect to any employment tax deficiency, and for 60 days thereafter.
 - (2) Certain Action Not Takan Into Account. For purposes of the second and third sentences of subsection (e), the filling of a proof of claim or request for payment (or the baking of any other action) in a case under title 11 of the United States Code shall not be treated as action provibinted by such second sentence.

The following are proposed amendments to Chapter 66 of Subtitle F:

- Section 6503(a)(1) of Chapter 66 shall be amended to read as follows (the new language is underlined):
- "(a) Issuance of Statutory Notice Of Deficiency or Notice of Employment Tax Deficiency. --
- (1) General Rule. The running of the period of limitations provided in section 6501 or 6502 (or section 6229, but only with respect to a deficiency described in section 6230(a)(2)(A)) on the making of assessments or the collection by levy or a proceeding in court, in respect of any deficiency as defined in section 6211 (a) states or in section 6231 (a) the section 6211 (a) and the section 6212 (a) or under section 6252 (a) the supended for the period during which the Secretary is prohibited from making the assessment or from collecting by levy or a proceeding in court (and in any event, if a proceeding in respect of the deficiency is the deficiency is described on the dockst of the Tax Court, the District Court, or the Claims Court, until the decision of such court becomes final), and for 60 days thereafter."
- Section 6512 of Chapter 66 shall be amended to read as follows:
- SEC. 6512. LIMITATIONS IN CASE OF DEFICIENCY PROCEEDINGS IN COURT.

- (a) [Same language as current provision]
- (b) [Same language as current provision):

The current subsection (c) shall be redesignated as subsection (a). There shall be added now subsections (c) and (d) as follows:

- (c) Effect Of Deficiency Proceeding In U.S. District Court or Claims Court. If the Secretary has mailed to the taxpeyer a notice of employment tax deficiency under socion 6252(a) (relating to deficiencies of certain employment taxes) and if the taxpeyer files a complaint with the U.S. District Court or the Claims Court within the time presenthed in section 6253(a), no credit or refund of employment tax for the same taxable year with respect to which the Secretary has determined the deficiency shall be allowed or make and no suit by the taxpeyer for the roovery of any part of the tax shall be instituted in our except
 - (I) As to over payments determined by a decision of the U.S. District Court or the Claims Court which has become final; and
 - (2) As to any amount collected in excess of an amount computed in accordance with the decision of the U.S. District Court or the Claims Court which has become final; and
 - (3) As to any amount collected after the period of limitation upon the making of lavy or beginning a proceeding in court for collection has expired; but in any such claim for credit or refund or in any such suit for refund the decision of the U.S. District Court or the Claims Court which has become final, as to whether such period has expired before the notice of employment tax deficiency was mailed, shall be conclusive.
- (d) Overpayment Determined By U.S. District Court or Claims Court.
 - (1) Jurisdiction To Determine.—Except as provided by paragraph (3), if the U.S. District Court or the Claims Court finds that there is no employment tax deficiency and further finds that the taxpayer has made an overpayment of employment taxes for the same taxable year with respect to which the Socretary has determined the deficiency, or finds that there is a deficiency but that the taxpayer has made an overpayment of such tax, the U.S. District Court or the Claims Court shall have jurisdiction to determine the amount of such overpayment, and such amount shall, when the decision of the U.S. District Court or the Claims Court has become final, be credited or refunded to the taxpayer.
 - (2) Jurisdiction To Enforce. If, after 120 days after a decision of the U.S. District Court or the Claims Court becomes final, the Secretary has failed to refund the overpayment determined by such court, together with the interest thereon as provided in subchapter B of chapter 67, then the U.S. District Court or the Claims Court, as applicable, upon motion by the taxpayer, shall have jurisdiction to order the refund of such overpayment and interest.
 - (3) Limitation On Amount Of Credit Or Refund. No such credit or refund shall be allowed or made of any portion of the tax unless the U.S. District Court or the Claims Court determines as part of its decision that such portion was paid —
 - (A) after the mailing of the notice of employment tax deficiency
 - (B) within the period which would be applicable under section 6511(b)(2), (c), or (d), if on the date of the mailing of the notice of employment tax deficiency a claim had been filed (whether or not filed) stating the grounde upon which the U.S. District or the Claims Court finds that there is an overepyment, or
 - (C) within the period which would be applicable under section 6511(b)(Z), (o), or (d), in respect of any claim for refund filed within the applicable period specified in section 6511 and before the date of the mailing of the notice of employment stat deficiency
 - (i) which had not been disallowed before that date.
 - (ii) which had not been disallowed before that date and in respect of which a timely suit for refund could have been commenced as of that date, or
 - (iii)in respect of which a timely suit for refund could have been commenced as of that date and within the period specified in section 6532.

The following are proposed amendments to Chapter 67 of Subtitle F:

- Sections 6601(c) and 6601(e)(1) of Chapter 67 shall be amended to read as follows (the new lenguage is underlined):
- "(c) Suppossion Of Interest In Certain Income, Estate, Gift Tax Cases And Certain Encises and Employment Tax Cases.— In the case of a deficiency as defined in section 6211 (relating to income, estate, gift, and certain excise taxes) and as defined in section 6213 (relating to certain employment taxes); if a waiver of restrictions under section 62134 or 6235(d) on the assessment of such deficiencies is not made within 30 days after the filing of such waiver, interest shall not be imposed on such deficiencies for the period beginning immediately after such 30th day and ending with the date of notice and demand and interest shall not be imposed during such period on any interest with respect to such deficiency for any prior period."
- "(e) Applicable Rules. Except as otherwise provided in this title -
- (1) Interest Treated As Tax. Interest prescribed under this section on any tax shall be paid upon notice and domand, and shall be assessed, collected, and paid in the same manner as taxes. Any reference in this title (except subchapters B might go described as the collection of the same manner as taxes. Any reference in this title (except subchapters B might go described as the same manner as taxes.)
- Sections 6665(b) of Chapter 68 shall be amended to read as follows (the new language is underlined):
- *(b) Procedure For Assessing Certain Additions To Tax. For purposes of subchapter B and E of chapter 63 (relating to deficiency procedures for incomes, estate, gift, and certain excess and employment taxes), subsection (a) shall not apply to any addition to tax under section 651, 6554, 6655; scoopt that is shall apply —
- (1) in the case of an addition described in section 6651, to that portion of such addition which is attributable to a deficiency in tax described in 6211 or 6251, or*

The following are proposed amendments to Chapter 76 of Subtitle F:

- Section 7421(a) of Chapter 76 shall be amended to read as follows (the new learnage is underlined):
- (a) Tax. Except as provided in section 6212(a) and (c), 6213(a), 6252(a) and (c), 6252(a), 6672(b), 6694(c), 7425(a) and (b)(1), and 7429(b), no mit for the purpose of restraining the sessessment or collection of any sax shall be maintained in any court by any person, whether or not such person is the person against whom such tax was sessessed.

The above are the primary amendments to title 26 that are necessary to allow a taxpeyer to contest most proposed worker reclassification cases (i.g., where there is no intentional disregard of the rules) in the U.S. District Court and Claims Court using deficiency procedures prior to the assessment of additional employment taxes. In addition, emendments may be necessary to title 28.

Chairman JOHNSON. Thank you. Ms. Horton.

STATEMENT OF DEBBI-JO HORTON, CPA, OWNER, DJ HORTON & ASSOCIATES, EAST PROVIDENCE, RHODE ISLAND; AND NEW ENGLAND REGIONAL TAXATION IMPLEMENTATION CHAIR, WHITE HOUSE CONFERENCE ON SMALL BUSINESS

Ms. HORTON. Thank you, Madam Chairman and Members of the Subcommittee. I think I am the only nonattorney on the panel. I am also the New England Regional Taxation Implementation Chairman to the 1995 White House Conference on Small Business, and I represent the National Taxation Implementation Chairs at today's hearing.

The two bills referenced in my testimony are H.R. 1972 and S. 1610. Representatives of the Taxation Implementation Team have been asked to clarify these two bills by this Committee in earlier hearings, members of the House and Senate Small Business

Committees, the IRS, and Treasury.

The legislation should be a clear general rule that will address the majority of independent contractors and not the exceptions. We will never satisfy all cases, and we shouldn't be attempting to do so. Those that do not meet a clear general rule will still fall under the 20-factor test in section 530.

Changes to the current bills that the Taxation Implementation Chairs have proposed are outlined in my written testimony. The essence of these changes is to close many of the loopholes that would allow the employer to force an employee to become an independent contractor, eliminate contractual language that should be left to the two parties to draft and execute themselves, force the independent contractor to comply with other points to show an intent to be in business and maintain independence, and not place a burden on States and their agencies to make additional provisions available.

In addition, we would like to propose to add language that would directly address the issue of control. All of these provisions should be a requirement of being an independent contractor in addition to meeting the other tests provided in the bills. If this Congress can pass a clear general rule that practitioners and small businesses can follow, there will be greater compliance.

Many service recipients currently do not file Form 1099s for fear of audit. If they are certain that they are correct in their classifica-

tion, they will be confident and comply.

We Taxation Chairs feel, however, that the bills could go a little further to assure this. So, in addition to technical corrections to the bills, the Taxation Chairs would also propose that the following be considered. First, service recipients should pay increased penalties for failure to issue Form 1099s. Second, service recipients should pay increased penalties for fraudulently misclassifying employees as independent contractors to evade the payment of taxes.

Additionally, there is a misconception that using an independent contractor is cheaper than hiring an employee. This is not true, and as practitioners, the Tax Chairs could argue this for years, but instead we offer these suggestions. Institute an employee referral

program. A general guideline is outlined, again, in my written testimony.

Also, with a clear definition, the interpretation of the current business relationships may need to change. The Tax Chairs ask that reclassification be allowed in the following manner. First, that the service recipient can obtain approval from the IRS to reclassify from an employee to an independent contractor, there should be a period of time when this would be allowed when it is clear that with the new rules they should be treated in this manner. Second, service recipients can reclassify from an independent contractor to an employee; A: without penalty or back taxes if the independent contractor has paid their self-employment taxes or; B: without penalty but back taxes paid by the independent contractor if the independent contractor is not current with paying their self-employment taxes.

If the service recipient has filed their Form 1099, there should be no penalty imposed on the service recipient, and a correction period for the independent contractor who hasn't paid their self-employment taxes should be instituted allowing them to pay their tax without penalty or interest. This will get them into compliance.

If the service recipient didn't file a Form 1099 and the independent contractor didn't file or pay their self-employment taxes, then they would not be entitled to this correction period. It is crucial to clarify this issue. It is equally crucial to do it without adding a tremendous paperwork burden to either the service recipient or the service provider.

Madam Chair, I thank you and your Subcommittee for pursuing this issue, and I appreciate your attention to the White House Conference recommendations.

As this congressional session comes to a close soon, I ask that you act swiftly and definitively on clarifying the definition of independent contractor. I hope that the recommendations made in this testimony will allow you to accomplish that, and the Taxation Implementation Chairs offer their expertise and assistance in providing any additional information to facilitate the task before Congress pertaining to this issue.

[The prepared statement follows:]

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Testimony of Debbi-Jo Horton, CPA
New England Regional Taxation Implementation Chair to
the 1995 White House Conference on Small Business
Before the Subcommittee on Oversight
of the
House Committee on Ways & Means
June 20, 1996

Madame Chair and Members of the Committee, I am Debbi-Jo Horton, a CPA and owner of an accounting firm in East Providence, Rhode Island. I am the New England Regional Taxation Implementation Chair to the 1995 White House Conference on Small Business and represent the National Taxation Implementation Chairs at today's hearing.

The two bills referenced in this testimony are HR 1972 and S 1610. Representatives of the White House Conference Taxation Implementation Team have been asked to clarify these two bills from this Committee in earlier hearings, Members of the House and Senate Small Business Committees, the Internal Revenue Service, and the Department of Treasury.

Additional points I would like to cover are:

- There is a lack of understanding by independent contractors on how the lack of clarity of the current laws
 affect them.
- Definitions of an independent contractor are different for federal classification and for each state's classification. States have their own interpretation of the federal definition.
- 3. The calculation of the estimated cost assessed by General Accounting Office (GAO) on the legislation to clarify the definition of the independent contractor may be incorrect. The Taxation Chairs are concerned that the estimated cost of this bill has been placed at \$1.1 billion over the next 7 years and may include items in the calculation that should have been omitted.
- 4. There is a need for a clear general rule rather than trying to define every possible scenario that might occur.

Point 1.

There is a lack of understanding by independent contractors on how the lack of clarity of the current laws affect them. Often when discussing the issue of independent contractor vs. employee it is viewed to be the "employer's" or "service recipient's" problem. What many fail to see is that it is equally the "employee's" or "independent contractor's" problem as well.

Let me give you an example. I spoke to a group of entrepreneur's that owned home based businesses. They were not very interested in the independent contractor vs. employee issue because they felt it didn't affect them. They indicated that this was so because they did not use independent contractors. When I asked if they considered themselves to be independent contractors their response of a resounding "OF COURSE!"

I then asked if they would be concerned if a company that used their services was audited and all of their independent contractors were reclassified as employees. They suddenly realized that this would directly affect them.

I am afraid that there are many more people in this country that have not looked at this issue as closely as they should. When they do, you will be hearing many more voices added to those already crying out for clarity.

The majority of businesses in this country either use independent contractors or are independent contractors. Most often they are independent contractors and use independent contractors. The job growth in the country has been attributed to small business (independent contractors make up the majority of this sector). Home based business and service are some of the fastest growing industries in the country. This issue is a concern to ALL of those companies.

Women represent the largest and fastest growing sectors of the small business community. Women account for a majority of the start up small businesses in this country, and a majority of them are independent contractors. This means that more women are entering the arena as independent contractors than ever before. The National Association of Women Business Owners views the independent contractor issue as their top concern. The Business and Professional Women's Federation/USA has also seen an increase in membership of women business owners. The independent contractor issue has been a topic of concern to their members and was included as one of the topics at their National Conference July, 1995.

Point 2.

Definitions of an independent contractor are different for federal classification and for each state's classification. Because of the lack of clarity, states have their own interpretation of the federal definition. We need to have clarity and consistency. If the federal government has clear guidelines, the state will follow them. States need to be able to start with the federal definition and be more consistent in its interpretation to define who is an independent contractor for state purposes. Currently this does not exist.

As an example, Rhode Island's law to identify an independent contractor is too restrictive. The State's law does not allow for an independent contractor to provide services to a company for which those services are part of that company's usual trade, occupation, profession or business. This type of independent contractor would be classified as an employee. For example, if an accounting firm wished to engage the services of my firm, they could not contract with my firm as an independent contractor. They would have to hire my firm (me) as an employee because of the State of Rhode Island's independent contractor law. They would be able to classify me as an independent contractor for federal purposes, but not for state purposes. This would put them at risk of reclassification if they were to be audited by the IRS because of the inconsistency in their treatment of that same individual.

The independent contractor becomes that company's employee for Rhode Island tax purposes. Income taxes, unemployment and temporary disability insurance is submitted to the State. In addition if that independent contractor has employees of their own, those employees become the service recipients employees as well under Rhode Island's law.

This affects the calculation of unemployment taxes for federal reporting. The federal form 940 requires the amount of wages that unemployment is being calculated on for each state. Rhode Island's wages will differ from the amount being reported to the IRS and could trigger an inquiry or an audit.

Rhode Island is collecting unemployment taxes, but the independent contractor is not entitled to the benefits afforded under the unemployment laws. I operate my business as a sole proprietor and as such do not receive wages from my company. I am not subject to unemployment taxes on either a state or federal level. However, if an accounting firm uses my services and pays me a "wage" for Rhode Island taxing purposes I am not allowed to collect unemployment when I no longer perform services for that company. Rhode Island is collecting the tax for a benefit they will never have to pay.

I have been trying to facilitate changes in the Rhode Island laws. My efforts have been an attempt to bring Rhode Island into conformity with federal laws. The legislature has been unwilling to change these laws because they can't interpret the federal definition, and indicate that the federal laws are too vague. In communications with the Director of the Rhode Island Department of Employment and Training (RIDET), he has consistently shown an unwillingness to discuss the issue with an open mind. I will share with you some of his direct comments made in letters to me. He opposes clarifying the definition of independent contractor because,

"Liberalizing the time tested and court test definition of independent contractor would allow thousands of employees to slip through the safety net of coverage for both unemployment insurance and temporary disability insurance. Please understand that one of our primary purposes for being is to provide safety net insurance coverage for employees in Rhode Island."

The Director insists that Rhode Island and the federal government are consistent in their laws. His Department has indicated a willingness to work with the employer community providing rulings on employer/employee or independent contractor status if they receive a written statement of the facts and circumstances. This would mean that I need to write for a ruling each and every time I perform work for another accounting firm. The Director of RIDET insists that the federal and state governments are listening, but goes on to say.

"Although DET is not willing to support changes, which we do not believe are in the best interest of the diverse employer and employee constituency we serve, we will continue with a demonstrated willingness to work for both employer and employee alike."

Point 3

The calculation of the estimated cost assessed by GAO on the legislation to clarify the definition of the independent contractor may be incorrect. The Taxation Chairs are concerned that the estimated cost of this bill has been placed at \$1.1 billion over the next 7 years and may include items in the calculation that should have been omitted. We have been unable to get a clear picture of how that estimate was calculated.

The IRS doesn't determine if the independent contractor has already paid their share of the tax when they assess the service recipient under reclassification. Does the estimated cost of the bill take into consideration that the taxes may be being collected twice? The IRS certainly doesn't attempt to contact the independent contractor and inform them that they were reclassified as an employee and they may be due a refund for taxes paid. The estimate might be reduced by this refunded amount due if they did in fact count the collection twice.

In discussions with the IRS, the Taxation Chairs indicated that we were concerned that penalty and interest may have gone into the calculation. We were told by representatives of the IRS that the IRS doesn't assess penalties in the case of reclassification. They only assess taxes and interest. We were told that interest did not go into the calculated estimate. The doubling of taxes in the case where intentional misclassification is determined we are told is not a penalty, rather it is an additional tax. Intentional misclassification does not need to be proven by the IRS, and they can double the tax amount due.

Call it what you will, but it is clearly not tax due. You are being penalized! If the IRS provided the amounts for the calculation, I am sure that there is "penalty" included. An independent contractor with a contract, who has been reclassified as an employee by the IRS and a determination was made that is was intentional misclassification would result in the following:

- 100% of the employer's FICA & Medicare and 100% of the employee's FICA & Medicare; 100% of the income taxes that would have been withheld assuming the contractor was single with one exemption.
 - 2) A penalty would be assessed at 100% of the tax.
- 3) In addition the IRS could assess penalties for failure to file employment forms, failure to make timely deposits, accuracy-related penalty for negligence or substantial understatement of taxes, penalty for civil fraud, and even aiding and abetting the understatement of tax liability.

Personal liability exists for "trust fund" portions of these taxes and 100% penalty for failure to file cannot be discharged in bankruptcy.

An example, is what happened to a Smithfield, RI company. They were contacted by an IRS Agent. He asked if he could stop by to discuss the independent contractor vs. employee issue. They were assured that this was not an audit. It was an informative interview only.

They cooperated and were very forthcoming in their interview with the agent. Shortly after completion of the interview, they were again contacted and informed that a payroll and subcontractor audit would be conducted.

The IRS reclassified ALL of their subcontractors as employees for the years 1986-1988 and assessed penalty, interest and all portions of payroll taxes for both employer and employee. They were assessed a total of

\$72,000 and were told that a certified check must be delivered within 24 hours or a one and one half times penalty would be assessed bringing the total to \$108,000.

This company hired legal council and spent the next two years fighting this assessment, incurring \$10,000 in attorney fees. The IRS settled for \$38,000, and required that affidavits signed by each independent contractor certifying that they had paid their self-employment taxes. The IRS refused to access their own databases to determine if the independent contractor had filed a Schedule C. They required that this company contact each individual independent contractor on their own to ascertain if the proper taxes had been paid.

The IRS claims that it doesn't care how people are classified so long as everyone is paying their taxes, yet they don't look at the independent contractor to see if they are paying their taxes before they reclassify and assess taxes and interest to the service recipient. They have tremendous matching capabilities and can access a Form 1040 quicker and at a lesser expense than the service recipient can contact that independent contractor (whom they may not be doing business with any longer) and obtain an affidavit from the independent contractor that they have paid their self employment taxes. This contradicts the IRS's claim.

The Taxation Chairs are also concerned that the GAO calculations include unemployment taxes. Besides the fact that independent contractors are not entitled to unemployment benefits, it is not clear if the calculation offset the collection of unemployment tax by the expense of providing unemployment benefits. In essence, we argue that the cost estimate may not be valid.

Point 4

There is a need for a clear general rule rather than trying to define every possible scenario that might occur.

The current legislation would allow too many workers to be reclassified from employees to independent contractors when they should be classified as employees. The legislation should be a clear general rule that will address the majority of independent contractor scenarios not the exceptions to the norm. We will never satisfy all cases, nor should we be attempting to do so. Those that do not meet a clear general rule will look to the current 20 factor test rules and the section 530 safe harbor for additional review and determination.

Recommendations to proposed legislation:

Current changes that the Taxation Implementation Chairs to the 1995 White House Conference on Small Business propose are as follows:

1) Delete from HR 1972: 3(b)(3) "agrees to perform the services for a particular amount of time or to complete a specific result and is liable for damages for early termination without cause."

Delete from S 1610: 3(b)(3) "agrees to perform the services for a particular amount of time or to complete a specific result and is liable for damages for early termination without cause,"

This is contractual language and should be left to the parties involved in drafting and executing their contract and not be part of the general rule.

 Change in HR 1972 in 3(b)(5): "purchases products for resale" to "primarily purchases products for resale".

Change in S. 1610 in 3(b)(5): "purchases products for resale" to "primarily purchases products for resale".

The current wording would allow an individual to purchase minimal products for resale and meet one of the tests when they would not be able to meet any of the other investment tests. The reasoning for making this a point in the test was to include resalers. An example would be an Agway or Avon representative and these are clearly examples of an independent contractor and not an exception.

 Add in HR 1972: 3(c)(1) "(D) operates primarily from equipment not supplied by the service recipient; and"

Change in S 1610: 3(c)(1)(D) "or" to "and"

4) Change in HR 1972: 3(c)(2)(A) "and" to "or"

Change in S 1610: 3(c)(2)(A) "and' to "or"

5) Add in HR 1972: 3(c)(2)(B)(ii)(II) "or" after "solicitations,"

Add in S 1610: 3(c)(2)(B)(ii)(II) "or" after "solicitations,"

6) Delete in HR 1972: 3(c)(2)(B)(IV) "other similar activities, or "

Delete in S 1610: 3(c)(2)(B)(IV) "other similar activities, or "

These changes would force the independent contractor to comply with other points that show an intent to be in business and maintain independence. It also closes many loopholes that would allow an employer to force an employee to become an independent contractor.

7) Change in HR 1972: 3(c)(B)(iii) "with" to "as required by"

Change in S 1610: 3(c)(B)(iii) "with" to "as required by"

Not all states or municipalities require that a license be obtained or that a sole proprietor register under a business name. If there is no provision to do these things then they would not be classified as an independent contractor. Rather than put an additional burden on states and their agencies to make these provisions available, we would rather leave these requirements to the states to administer in their current manner.

8) Add to HR 1972: The service provider must be free from ongoing direction or control over the means and manner of providing the labor or service, other than through general performance specifications, and basic project specific variables such as the workorder, job site, date, or date. In addition the service provider has the right to hire employees to help perform the labor or service, and is responsible for employer taxes and required reporting for workers who they hire or supervise on a regular basis, except in the circumstances where specific services are required without substitution. Lastly, the service provider does not receive from the contracting party any of these benefits which are normally associated with an employment relationship, payment for holidays, vacation time or weekly overtime; and the service provider cannot participate in the service recipient's employee benefits programs such as employer retirement programs, health or life insurance benefits, or other benefits normally available only to employees.

Add to S 1610: The service provider must be free from ongoing direction or control over the means and manner of providing the labor or service, other than through general performance specifications, and basic project specific variables such as the workorder, job site, date, or date. In addition the service provider has the right to hire employees to help perform the labor or service, and is responsible for employer taxes and required reporting for workers who they hire or supervise on a regular basis, except in the circumstances where specific services are required without substitution. Lastly, the service provider does not receive from the contracting party any of these benefits which are normally associated with an employment relationship; payment for holidays, vacation time or weekly overtime; and the service provider cannot participate in the service recipient's employee benefits programs such as employer retirement programs, health or life insurance benefits, or other benefits normally available only to employees.

These provisions directly address the issue of control. All of these provisions should be a requirement of being classified as an independent contractor in addition to meeting the other test requirements.

In addition to these technical corrections to the bills outlined above, the Taxation Chairs would also like to propose that the follow be added to these bills:

- Service recipients should pay increased penalties for failure to issue 1099s to their independent contractors.
- Service recipients should pay increased penalties for fraudulently misclassifying employees as independent contractors to evade the payment of taxes.

If this Congress can pass a clear general rule that practitioners and small businesses can follow, there will be greater compliance. Many service recipients currently do not file 1099s for fear of audit. If they are certain that they are correct in classifying their independent contractors, they will be confident in their compliance and will file the appropriate forms. We, Taxation Chairs, feel however, that the bill could go a little further to assure this.

A misconception that many people have is that using independent contractors is cheaper than hiring an employee. This is not true. An independent contractor charges a rate that incorporates their costs. These costs include overhead, benefits, and the cost of doing business (which includes paying their taxes). Because of this misconception and other factors there are people who fear that the passage of a clear general rule to define an independent contractor will allow employers to fire their employees, and make them sign contracts as independent contractors to regain their job. As practitioners, the Taxation Implementation Chairs could argue for years on this point, but instead we offer these suggestions:

3) Institute an Employee Referral Program.

This would allow an employee to contact the IRS to discuss whether a reclassification by their employer is justified. Currently Form SS8 is supposed to be used for such an instance, but the form is too cumbersome and too complicated to be useful. We would recommend that the form either be made simpler to use or a hotline be instituted where an employee can call when they feel a reclassification is unjustified by their employer and the IRS employee can take down pertinent information and have a determination rendered.

4) Reclassification:

A) Service recipient can obtain approval from the IRS to reclassify from employee to independent contractor.

Because of the unclear definition that we currently have, many companies make it standard procedure to only hire employees. They do this out of fear of reclassification under audit and the hardship they have seen others endure because of the subjective nature of the current laws. Once we pass a clear general rule everyone will reassess the current classifications they have and some may find that they have an independent contractor relationship rather than an employee relationship. When this is the case they should be allowed to reclassify without fear of retribution.

Allow a period of time where the service recipient can obtain approval from the IRS to reclassify from employee to independent contractor when it is clear that with the new general rule they should be treated in this manner.

- B) Service recipient can reclassify from an independent contractor to employee;
 - without penalty or back taxes if the independent contractor is current in paying their self employment taxes.

With a clear definition a service recipient may determine that they have an employee relationship. That service recipient relied on current law and interpreted their business relationship to be one of independent contractor, but now that the definition is more clear, they believe that the relationship is one of employer/employee. Circumstances in the relationship need not change to change the interpretation, but the clarity of the definition and as a result the interpretation leads to the change.

If both the service recipient and the service provider agreed they had a service recipient/independent contractor relationship, they would have been complying with the law. Form 1099 would have been filed and the independent contractor would have paid their taxes. Therefore the reclassification should be allowed without penalty or back taxes to either party.

without penalty, but back taxes paid by the independent contractor if the independent contractor is not current with their self employment taxes.

In this scenario the service recipient has interpreted the current law to indicate that the relationship is that of service recipient/independent contractor and under the new clear definition sees that it would be classified as an employee. If the service recipient has filed their form 1099, there would be no penalty imposed.

Institute a correction period for reclassification from independent contractor to employee where the independent contractor hasn't paid their self-employment taxes. Allowing them to pay the taxes without penalty and interest.

New Jersey has just completed a very successful amnesty period that brought many taxpayers into compliance and brought revenues into the state.

If the service recipient did not file form 1099 and the independent contractor did not pay their self employment taxes, they would not be entitled to the correction period and would fall back into the 20 factor test and Section 530.

It is crucial to clarify this issue. It is equally crucial to do it without adding a tremendous paperwork burden to either the service recipient or the service provider.

Madame Chair, I thank you and your Committee for continuing to pursue this issue. As this Congressional session comes to a close soon, I ask that you act swiftly and definitively on clarifying the definition of an independent contractor. I hope that the recommendations made in this testimony allow you to accomplish that. The Taxation Implementation Chairs offer their expertise and assistance in providing any additional information to facilitate the tasks before Congress pertaining to this issue.

Chairman JOHNSON. I thank the panel.

Ms. Horton, your suggestions in regard to an employee referral program, are very interesting. There were quite a few parts of your testimony that were interesting. I especially like the suggestion to develop a system whereby there can be better communication between the taxpayer and the IRS in the course of making these changes in both directions.

Mr. Shulman, you acknowledged that there is concern that if Congressman Christensen's legislation were enacted that it might actually allow employers to coerce their workers into being treated as independent contractors. Do you have any suggestions for fine tuning the language in the congressman's bill to prevent this

coercion?

Mr. SHULMAN. Well, I have heard that said, and I think there are a number of ways it can be handled. One way that I have heard talked about is actually exempting some categories of workers or some industries from the test in the Christensen bill.

So, for example—and I do not mean to prejudge this because I do not know a lot about this industry—but in past years, there have been hearings about migrant laborers who have been coerced into being independent contractors. I think Congress can do with that group of workers as it has done historically with other groups who it felt were potentially being abused and say you make or break your case under the common law test, you do not get the

Christensen standard. That is one way to do it.

I know the other provisions of the bill can be fine tuned, but again, Madam Chair, my concern is, with all due respect to the other witnesses, we are moving into the 21st century. We have lots of jobs that we need to think about in different ways. We need to empower people, particularly those who are not being abused, knowledgable workers, our programmers/analysts, and people in the high-tech community who want to work self-employed to be able to do that, and whatever changes we make in any of this legislation, we must not only look backward and see who we want to continue to protect, but we must look forward and make sure that whatever test we come up with allows the workers who we want to encourage to be self-employed to have that opportunity.

Chairman JOHNSON. I think that is a very legitimate point.

You also mentioned that we should change the assessment process in employment tax audits. Can you describe the problems you see with the current assessment process a little more in depth?

Mr. Shulman. I think, Madam Chairman, that this is one of the most outrageous aspects of this problem that never gets discussed, and that is if Donald Trump were found to owe \$100 million in income taxes, the IRS would issue a notice of tax deficiency and Mr. Trump would have his day before a judge in court and be able to show he did not owe a penny before the IRS could impose a lien or assessment on him. However, if a small business is found by the IRS to have misclassified, even in good faith, and that small business wants to go to court to contest that, and let us just say it is a \$100,000 assessment that could put that business out of business, under the current law, the IRS is required to make an assessment, and that becomes an immediate lien on the business. And you know something, there are very few small businesses that have

the wherewithal to survive that lien and go to court and fight the

IRS no matter how correct they may be.

My testimony has a lot of details on changing that procedure. I was glad to hear Treasury suggest maybe it should be in the Tax Court. I do not think it should be in the Tax Court, but we have got to change the assessment procedure or all of the other things you are doing here are almost going to be meaningless because if you disagree with the IRS, they are going to hang you before you ever get a chance to prove your case.

Chairman JOHNSON. Thank you. That has been a significant

problem, and we heard a lot about that last session.

Mr. Kleczka.

Mr. KLECZKA. Thank you, Madam Chairman.

Let me ask Mr.—is that Campagna?

Mr. CAMPAGNA. Campagna. Mr. KLECZKA. Campagna.

What is your view of the Christensen bill that is currently pending before this Subcommittee? I am going to ask that of the New York folks, also.

Mr. CAMPAGNA. I can only answer personally because the Section

has not taken a formal position on the bill.

The first point I would make to you, Mr. Kleczka, is I do not think there would be as many wholesale reclassifications of workers as might be expected, and the reason is the Criteria C of the Christensen bill which requires either a principal place of business or true liability if the worker walks off the job.

It is very difficult for me to see where that allows big companies to just start willy nilly reclassifying people because they would have to have one of those two things, and they wouldn't have it in

the typical case.

Mr. KLECZKA. Have you had a chance to review the GAO criteria that was presented today, along with, I think, the New York State Bar, also with four criteria? Have you reviewed either one of those?

Mr. CAMPAGNA. I have reviewed the GAO bill in the past, and I have heard Ms. Kraus' definitions this morning. I have disagreements with just about every objective criteria that have been drafted.

As I mentioned in my written statement today, we are not here pushing even the objective criteria that were proposed by the American Bar Association in 1982 because times have changed, and there are some minor details in there that we would change if we were asked today for objective criteria.

Mr. KLECZKA. Let me ask either Sherry or Mr. Reinhold their

views on the Christensen bill.

Mr. REINHOLD. Mr. Kleczka, We were of the view that the criteria are sensible criteria, but because of the limited nature of the criteria used, taxpayers could effectively elect classification as either employees or independent contractors under the bill. We gave a couple of examples in our statement about workers that, in all respects, appeared to resemble traditional employees, except they might hold themselves out as available to third parties and briefly work for third parties during a year or might work from a facility adjacent to their home using a PC, not terribly unusual things in 1986, certainly in the second category and possibly in the first, and

thereby put themselves in a position where they would be able to claim independent contractor status. We had some concern that there would be substantial erosion of the employee concept if it were so readily elective.

Mr. KRAUS. Sir, if I could just add to that comment. In our report, we actually give an example of what we believe would be one

of the problems with the Christensen bill.

For example, if you had a worker who simply could show some investment in training, maybe trade school, college or whatever, got a DBA—this costs about \$20 to do—and entered into a written agreement with his employer agreeing to be treated as an independent contractor, that is all you would have to meet. That would be one example of how simple it would be to meet independent contractor criteria under that bill. That is only one, but that is the kind of thing we are talking about in that we are worried that the pendulum will swing too far the other way and undermine employee status.

Chairman JOHNSON. Would the gentleman yield?

Mr. KLECZKA. Surely.

Chairman JOHNSON. I see heads nodding in disagreement. Would you mind if others commented to that point so we get some discussion between them?

Mr. KLECZKA. Sure, briefly. Go ahead.

Chairman JOHNSON. I am going to allow you time.

Mr. KLECZKA. Sure.

Chairman JOHNSON. Mr. Campagna, you were shaking your head, and, Mr. Shulman, I wondered if you had any comment.

Mr. CAMPAGNA. On the example just given, I fail to see how that worker would have his or her own principal place of business or would be liable at termination of the contract. I just do not see how that person would satisfy criterion C of H.R. 1972.

Chairman JOHNSON. Ms. Kraus.

Ms. Kraus. If I could respond. As I understand the bill, I read it sometime ago, there is actually a rather complicated test under the Christensen bill, and under the second test you would have to show that you had a principal place of business or paid fair market value for the business premises, but if none of those conditions were met, you would then be given an opportunity to meet yet another test which is to show that you had offered to perform services for others or provided services under a registered business name, which is where I got the DBA example.

So, unless I am misinterpreting the either/or aspect of that second test, which is I believe what the gentleman was referring to, it looks as though it gives you an alternative if you cannot show

you have a principal place of business.

Chairman JOHNSON. Any other comments?

Mr. KLECZKA. Mr. Shulman, do you want to respond briefly?

Mr. Shulman. Yes. I agree with Mr. Campagna that there are situations, and let us use a computer programmer or an accountant as an example. These people may take on a project which is on a customer's premises—because, by example, that is where huge amounts of records are kept in the case of an accountant, or for a programmer, there is a \$100-million computer there, and that person may literally have paid for their own continuing education,

their own self-training, they have an advanced degree. They do not need a principal place of business because they are not going to have a million-dollar computer in their home, but they will agree to finish the project and not walk off the project early. Now, that person would satisfy the Christensen test, but would not satisfy the test in a lot of these other bills. That is my point about looking at it from both sides. We want to prevent abuses, but we have to come up with something that works in the 21st century and that lets workers who are well educated, well paid, not abused, and who pay their taxes, to choose a working relationship with a firm that allows them to be young entrepreneurs.

So, I agree with Mr. Campagna. Under the Christensen bill in certain circumstances, people who take on that liability to complete a project would be an independent contractor, and I do not see anything wrong with that in the circumstances I have just set forth.

Chairman JOHNSON. Thank you.

Thank you, Mr. Kleczka.

Mr. KLECZKA. OK. Ms. Kraus, you are correct that a test to the Christensen bill starts with the principal place of business, and it goes through numerous other points. That clearly is not the defin-

ing criteria.

In your testimony, Ms. Kraus, you have a statement here, and I will just extrapolate from it. In the employer-worker relationship, there is a significant risk of undermining treatment of workers as employees. Do you want to expand on that? I think I made mention of that earlier in today's testimony that it is just not a case of whether or not the IRS and the Federal Treasury will be held harmless. There is a human side to this, and I think that is what you might be referring to. So, if you could briefly respond as to your thoughts on that.

Ms. KRAUS. Yes, I would be very happy to.

Again, I am a practitioner, and I see a lot of these cases, including, I might add, I have handled a case very similar to the one you discussed early on today on the educational systems, hiring out buses to owner drivers, which I won't go into but would be happy to expand upon later if you would like.

Basically, there is a tremendous financial incentive to employers, especially small business employers who have thinner margins of

profit, to try to find ways to reduce their worker cost.

I often see in my practice situations in which actually workers are coerced or they cannot get the job unless they agree to be treated as an independent contractor or there would be a somewhat quasi-collusive arrangement that I will not send you a Form 1099,

so you can not worry about the payment that I make.

One thing that concerned us in doing this report, the beginning of this report actually was several years ago with the health security bill because that bill knew that we had to clean up this area because they were trying to address who had to pay health benefits, and that all turned on whether you are an employee or not. That was going to put enormous pressure on the worker classification issue because suddenly if an employer has to pick up \$4,000 a year or more per worker to include them in a health plan, yes, there is going to be an additional incentive to define that worker, by the way, that should be treated as an independent contractor.

What I see a great deal in my practice is the workers end up not able to pay the full amount, meaning their own self-employment taxes as well as their fringe benefits, like health care cost and so on.

Empirically, based on my own experience, I believe many of these audits start with workers who actually file returns, report the income, but cannot pay, and then we deal with an offer and compromise or whatever, but there are tremendous losses to this system with the independent contractor status in many cases, even when there has been full compliance by everyone, employers and workers alike.

So, the issue is that if everything suddenly shifts to making independent contractor status more easily available, you do have to take into account monumental shifts not just in the tax area, but in the benefit area as well.

Mr. KLECZKA. Let me ask my last question of Ms. Horton. In your testimony, you indicated that independent contractors aren't cheaper than regular employees. What is your basis for that, based on the fact that a regular employee would carry a whole bunch of benefits along with him or her, where an independent contractor would get one payment, fee for service?

Ms. HORTON. Most independent contractors will make sure that

they have those benefits.

Mr. KLECZKA. From who?

Ms. HORTON. From themselves.

Mr. KLECZKA. Oh, provide it themselves. OK.

Ms. HORTON. I am a sole proprietor, but I have employees. My employees are entitled to health benefits. I also have health benefits. They have SEP contributions. I have SEP contributions. If I were to work for a CPA firm, I might get \$25 to \$30 an hour, and they would supply me with some benefits. As an independent contractor, I get \$150 an hour. Where is it cheaper to use an independent contractor versus an employee?

Mr. KLECZKA. OK, but that is an independent contractor who is a professional. Let us take a person who is a trades person versus

a professional. Would the same be true?

Ms. HORTON. Should be.

Mr. KLECZKA. \$150 an hour?

Ms. HORTON. Well, they might not get \$150 an hour, but they probably wouldn't get paid \$25 an hour as an employee either.

Mr. KLECZKA. Thank you very much.

Chairman JOHNSON. Just to pursue that issue, Ms. Horton, do you have any idea what percentage of the independent contractors are people like you who have employees and what percent is that sort of little tiny person who may not be able or willing to charge enough to provide benefits for either themselves or their employees?

Ms. HORTON. I do not know what the statistics are on a national basis, but Rhode Island is made up of almost 95 percent small business, and of that—

Chairman JOHNSON. In Rhode Island?

Ms. HORTON. Rhode Island.

And of that 95 percent, more than 50 percent of them have five or fewer employees.

Chairman JOHNSON. Thank you.

Does anyone else have any comment on the point just made? Mr. Shulman.

Mr. Shulman. If I may, Madam Chairman. In the computer industry, our employers make more money when we use employees than when we use independent contractors. We must pay, like Ms. Horton said, independent contractors more money because they pay for all their own benefits. They get their own liability insurance. So, again, you cannot make generalizations here.

I do admit to bristling when I hear a generalization that it costs more to use employees. It is absolutely not the case as a general

proposition.

Now, beyond that, Congressman Kleczka's point, which I agree with and I am very concerned about, we have got to distinguish between tax issues and other issues. This is a Ways and Means matter. We are not talking about OSHA. We are not talking about Title VII for equal employment. There is nothing uncommon about a worker being an independent contractor for some purposes and being an employee for other purposes. So, let us, again, strip away the rhetoric about—and I do not mean from the Congress, but from among many in the business community—about when someone becomes self-employed for tax purposes, they are going to lose all of these other protections. It just is not the case because the EEOC and the Labor Department and OSHA and everybody else is out there.

I think as we move forward, I urge you to keep those distinctions in mind.

Chairman JOHNSON. It would be useful, and we will try to get information from the GAO and others as to how many independent contractors have employees because, of course, any workplace would be covered by all of these other laws. If 95 percent of independent contractors actually have workplaces, then the points brought up earlier about lack of worker protection simply are not relevant, but I am concerned, Ms. Kraus, with your comment that there are tremendous financial incentives to reduce worker cost.

What I am hearing from Mr. Shulman and Ms. Horton is that what they bring to the table to a business—and I see this. I represent a district of small businesses, and that small manufacturer does not have the computer expertise, and the IRS didn't have the computer expertise to upgrade. They needed to hire that expertise from outside.

These little companies cannot hire the expertise they need, even on a short-term basis. They cannot reorganize their computer capability, upgrade their machinery, or redesign the layout of their plant. There are just so many things now that running a sophisticated business requires that small businesses cannot do. It would be dumb for them to hire someone. So, they need to hire an independent contractor, and this is a very legitimate role in our economy. Of course, that is driven by the desire to reduce cost.

You need to help us clarify because your statement is no more true than their statement. There is truth to both sides of this argument. You have to help us clarify this situation about what kinds of situations produce the coercion. Otherwise, we will have to draw bright lines without regard to what kind of protection we ought to be able to provide.

Do you have a comment?

Ms. KRAUS. Madam Chairman, certainly your point is absolutely correct. Probably, in most instances where a business or an employer hires a worker and treats that worker or group as an independent contractor, I do not know the statistics. My bet is in most cases, they are correct.

I mean, my goodness, especially in small business areas, the need to go outside and outsource that expertise is very frequently there. In those cases, they are probably going to be OK. They are

probably going to have no problem.

The only way they might have a problem is if the worker does not include it in income, and the IRS may come back and just make sure that they have complied with the Form 1099 requirements. Clearly there are many, many situations where it is perfectly legitimate.

Let us hope so. I am an independent contractor for every client I serve, and we are talking about this subsector, this tax gap sector where there are unscrupulous or uninformed, or whatever the reason, workers or pressured workers where they may have to agree.

Chairman JOHNSON. I understand that. So, how do we get at them without debilitating, in a sense——

Ms. KRAUS. Exactly.

Chairman JOHNSON [continuing]. Legitifying relationships in our economy which at this point is critical to our future that they be flexible? How do we do that?

Ms. Kraus. Well, again, the report makes a number of suggestions. The main thing is, of course, the reporting, the compliance provisions, pumping up the Form 1099, making sure the IRS has the tools to make intelligent selections of where is there abuse, and where is there not abuse.

Chairman JOHNSON. So, the kinds of things we have been discussing to fine tune this bill language.

Ms. KRAUS. Exactly.

And also, on audit, then if we can eliminate some of the vague criteria and have more bright-line tests, which this is just a guess, but I am going to guess, if you put in some bright-line employee tests and bright-line safe harbor tests, people are going to structure. This will determine how they structure their relationships with the workers that they want to treat as independent contractors or that they want to treat as employees, and you are going to have far fewer disputes in that area. but I certainly know, just addressing the points made by my colleagues, that in terms of the cost, I happen to have represented groups similarly situated, like dental groups.

One will treat them as independent contractors. It is a corporation. Another will treat them as employees. They are audited. They

get adjustments.

When we talk about the cost of employee versus the cost of independent contractors, those companies bitterly complain when they have to treat these workers as employees. They claim competitive disadvantage, what you had talked about with Mr. Lubick this morning, because the costs to them are greater.

Again, when we talk about this issue of is it more expensive to keep them as employees or to treat them as independent contractors, certainly you see bitter complaints in many areas. Some workers and companies are under the protection of section 530——

Chairman JOHNSON. Let us come back to that because I think that is a relevant thing to talk about, but I have taken more time than I should have when Mr. Hancock has not had a chance to

question.

Mr. Hancock.

Mr. HANCOCK. Thank you very much.

Because of the incentive, which I addressed a little bit earlier, which is out there to actually go with an independent contractor, what we are hearing today in front of this Subcommittee is primarily addressed at whether there is a tax advantage or disadvantage, and we are talking about Internal Revenue collecting the income taxes or the payroll taxes. Is that the number one reason for the drive in the marketplace now is to try to go with independent contractors? Does it have to do with the tax law whatsoever? Shouldn't we consider the other governmental regulations, which Mr. Shulman approached, such as the potential litigation if, in fact, you want to terminate an employee?

Let us face it. There is a whole industry out there in the legal profession just sitting and waiting for somebody to file a discrimination suit or for somebody to file workman's compensation or unemployment claims. Is there an unspoken and unwritten incentive to try to avoid litigation and having to defend and lose even if you win? Does that have a bearing on whether it is a tax deal, or is it that the employer is scared to death of being sued on something

that he does not have any control over?

Mr. CAMPAGNA. Mr. Hancock, if I might, it is impossible to segregate those reasons. When a company decides to treat workers as contractors, all of those matters come into play. It may be less expensive in their industry to have a contractor. It varies from industry to industry whether it is or not. It may be a problem in that industry to deal with workers who are terminated. It is in most. It may be a tax advantage. It just depends from industry to industry, and I think all of these things are intertwined. You cannot say the tax is driving the decision at this point because we are such a service economy now, and the types of professionals and entrepreneurs that we have been talking about are not the people that we need to protect with the very important concerns that Mr. Kleczka is raising, to protect workers from being reclassified.

We shouldn't be thinking about doctors and lawyers and accountants when we think about those things. Those people are getting paid enough wage to go out and get their benefits whether they

work as contractors or not.

If we are concerned about reclassification of workers and wholesale reclassifications by big companies, I would suggest that you try to incorporate a prophylactic provision in any of your objective tests that would say that a company could not reclassify a worker if there has not been a change in their true job function or proof that the company was entitled to rely on the section 530 safe harbors and simply hadn't been relying on those because it would have been inconsistent treatment to do so. If you put those prophylactic provisions in, companies will not be able to wholesale reclassify their workers as contractors just to avoid benefits.

Mr. HANCOCK. There is one item on here that we talked about on this section C. A primary source, is that what it is, that pays a fair market use, rent use for the service recipient's place of business. This means that you have got to have an office. What about the guy that is operating just out of his head? He has got the brains, and he does it over the telephone. Is he not self-employed even though he does not have the primary source? He uses a pay phone, operates out of his car, travels over the country as a consultant. Is he not self-employed?

Mr. CAMPAGNA. I understand, Mr. Hancock, that the trucking industry has a problem with that criteria because they do not know if the owner/operator of a truck is going to have a principal place of business that qualifies under that criteria. It is the same ques-

tion that you have raised.

Mr. HANCOCK. Quite frankly, Mr. Campagna, I just met with a trucker just a few minutes ago when I stepped out. Thank you.

Chairman JOHNSON. In view of the time, I think we will not be able to pursue our preceding discussion, but this has been a very helpful panel, and you will have a chance to comment as we try to pull your ideas together into a proposal. Thank you very much

for your participation today.

Let me move on to the next panel. I am sorry to keep the people waiting, but this is a difficult area, and I do think it is important for the Congress to begin taking on some of the problems that have, in a sense, plagued us for many years, and so it does take some greater time to get a grasp of what people are saying about the interrelationship between the recommendations that presenters are making, and I appreciate the patience of both the Members and those scheduled to testify.

This panel is Kurt Pfotenhauer—is that—

Mr. PFOTENHAUER. That is correct.

Chairman JOHNSON. Pfotenhauer. All right.

And James Pyles, Clyde Northrop, Lockwood Phillips, and Leonard Doctor. Before we begin, it is a pleasure to have with us Hon. Steny Hoyer.

Mr. HOYER. Thank you very much, Congresswoman Johnson and Congressman Hancock and Congressman Kleczka, who I believe

has stepped away.

Chairman JOHNSON. He will be back shortly.

Mr. HOYER. Thank you.

I appreciate this opportunity to appear before you today to introduce one of my constituents, Clyde Northrop, the president of the American Association of Independent Newspaper Distributors.

As he will tell you, Madam Chairman, Clyde has been a newspaper distributor since 1973. He knows the business and its people and will be able to share with the Members of the Subcommittee his insights into the particular egregious situation that has confronted him, his business, and his association members.

Mr. Northrop first came to me, Madam Chairman, in 1994 about a new interpretation of IRS rules that changed their status from independent contractors to that of employees. As the then-chairman of the Treasury Postal Subcommittee, I worked with the IRS to correct this misinterpretation. However, as you can tell, my efforts were not successful, and ultimately, the IRS indicated that a legislative solution was needed.

Essentially, Ms. Richardson said that counsel advised her that this was the correct interpretation and, therefore, we had to

address it legislatively.

Therefore, I was pleased that the Senate, at the instance of Senator Dole, included in its 1995 reconciliation bill a provision to clarify that under section 3508 of the Tax Code newspaper distributors can be treated as independent contractors under direct seller rules. Furthermore, important language was included in the report to clarify that the provision has no impact whatsoever on the interpretation of the applicability of Federal, State, or local labor laws.

As you may know, Madam Chairman, the Teamsters and others became very concerned about the ramifications this might have as it related to their existing contractors and relationship to various

newspapers. In particular, there was a problem in Detroit.

What this simple yet important provision does is return the newspaper distributors to the status quo they had been operating

under until recent interpretations by the IRS.

I am grateful that this Subcommittee supported the Senate language and that it was included in the conference report. Although the overall bill was vetoed by the President, I am hopeful that this provision will ultimately be signed into law and would appreciate the Subcommittee's continued support of the important provision.

I might say, Madam Chairman, that I had extensive conversations with the White House last year on this issue because, of course, it was somewhat controversial because of particularly the concerns of some in the labor movement with whom I was very

sympathetic.

At the same time, Madam Chairman, you may know that in Kansas, because they had the financial ability to do it and they got some help, I suppose, from the newspaper itself, they took this to the court, and before it was litigated the IRS withdrew, in effect, gave up on its claim in that instance. Obviously, most folks do not have that kind of resource, especially those folks who are very small businesses, mom and pop at best and teenagers.

Clyde was just telling me since this ruling, in Bowie, Maryland, there are no longer any teenaged delivery newspaper people. They are all gone because of the fact of the relationship. You know where Bowie is, just about 15 miles from here, the second-largest town in Maryland. It is about 45,000 people, second only to

Baltimore.

In any event, Madam Chairman, it is my pleasure to appear before you today to introduce Clyde Northrop, and I thank the Subcommittee for giving Mr. Northrop the opportunity to further

explain the situation that distributors find themselves in.

I told Mr. Northrop, but I will repeat it for the panel, that Chairwoman Johnson, as you may have already learned in your practices, is one of the more thoughtful Members of the Congress of the United States and I am sure will be very sympathetic to the representations you have to make.

Madam Chairman, thank you for giving me this opportunity.

Chairman JOHNSON. Thank you, and thank you for joining us, Congressman Hoyer.

It is of really great concern to me that government should go in and reinterpret relationships and, in a sense, retroactively knock out jobs that used to be available to kids.

Mr. HOYER. Yes.

Chairman JOHNSON. I hope that we will be able to solve at least this problem, but that same kind of retroactive redefining of relationships is having a lot of consequences in other industries that I think are unhealthy and unfair particularly in light of the section 530 safe harbor that explicitly said if there is a long history of classification then we will not disturb it.

So, we do have some good work that we can do in this area. We may not be able to solve every problem, but this is one I hope we will be able to solve—and I think your presence here—and at our first hearing, Senator Gramm came all the way over to our side. We clearly have bipartisan concern with fixing the law in this area, and I am very glad to know that you have had good conversations with the administration, and we may need your help later on to be sure that the communication is complete, but we also had very good testimony from Treasury and the IRS, and I believe we are going to be able to work together to iron out some of these things.

Mr. HOYER. Well, I look forward to working with you, and you

let me know what I can do to help.

Chairman JOHNSON. Thank you for being here this afternoon.

Mr. HOYER. Thank you.

Chairman JOHNSON. Let us start with Mr. Pfotenhauer, the vice president of UPS.

STATEMENT OF KURT PFOTENHAUER, VICE PRESIDENT, UNITED PARCEL SERVICE, WASHINGTON, DC

Mr. PFOTENHAUER. Good afternoon. As the Nation's fifth-largest employer, today's hearing is of significant interest to UPS.

A compelling case has already been made before this Subcommittee that the process by which the IRS determines who is and who is not an employee is overly subjective and produces inconsistent results. Clearly, guidance is needed from Congress.

It is UPS' recommendation that any legislation voted out of this Subcommittee effectively, but narrowly, target the problems of small business while addressing the broader issues associated with

worker classification on a more comprehensive basis.

Labor is the key asset in the delivery of our service to the public, and it will always be so. Despite enormous expenditures made annually by UPS for aircraft, fuel, facilities, and technology, about 60 percent of our overall cost is still attributable to labor.

While technology can most certainly enhance the effectiveness of our employees, it cannot replace individuals in providing our core

pickup and delivery service.

Our 82,000 drivers serve every community in this country; in fact, every address in this country. As most of the Members of this Subcommittee know from personal experience, our drivers are hardworking, determined, highly motivated individuals.

Experienced UPS drivers earn \$18.80 an hour. They get time and a half for overtime. With benefits, they make nearly \$30 an hour.

These are very good jobs, but if Congress enacts legislation without carefully examining its impact on these jobs and others like them, it could unintentionally shift the direction of our entire industry by offering huge competitive advantages to companies willing to consider replacing their employees with independent contractors.

By replacing its employees with independent contractors, a business can cut its labor costs dramatically. It can do away with the need to pay overtime, unemployment insurance, or worker's compensation. It can sidestep employer's responsibilities for Social Security, for disability benefits, for health benefits, for pension benefits. It can also avoid regulatory compliance requirements which

are triggered by threshold numbers of employees.

As an independent contractor, the former employee will enjoy fewer job protections, will probably make less money, will have less medical coverage, and will be less likely to retire with a pension. Taxpayers may end up shouldering the burden for increased social welfare demands, and with such looming economic impacts, businesses would be forced to make very hard choices regarding their employee-based work force in the face of competition from low-cost providers using independent contractors.

More liberal use of independent contractors will inevitably make employees obsolete in certain industry sectors. It seems, then, that there must be a balance. UPS suggests the following principles

upon which legislation could be fashioned.

First, the question of whether work is contracted out to independent contractors or is performed by employees of the company, should be a decision which is not significantly distorted by government-mandated requirements, penalties, and rewards. We need a level competitive playingfield.

Second, open and visible decisionmaking by the IRS is needed. If the government's decision will affect an industry and its jobs that needs to be done on an industrywide basis. Existing IRS decisions should also be reviewed and reconsidered for their perspective application under this statute.

Third, the control aspect of the common law test for determining employment status needs to be retained and strengthened, not

eroded.

Fourth, because independent contracting affects laws far beyond the Tax Code, corrective legislation should be comprehensive, not narrow.

Finally, small businesses are the incubators for innovative technologies and services and are stepping stones for economic development. Their needs and their resources and their challenge differ both in kind and degree from larger established businesses.

UPS picks up packages from over 1.3 million businesses a day. Most of these are small businesses. The success or failure of small business has a dramatic impact on UPS. Every 50 additional packages a day that a small business feeds into our system creates a job at UPS.

The predominant problems of IRS classification center on small business, and so should the solution. The other issues associated with worker classification should be addressed comprehensively.

Thank you for the opportunity to testify.

[The prepared statement follows:]

Testimony of Kurt Pfotenhauer Vice President United Parcel Service

before the

Subcommittee on Oversight Committee on Ways & Means U.S. House of Representatives

June 20, 1996

Good morning. My name is Kurt Pfotenhauer. I am a Vice President for United Parcel Service. As the nation's fifth largest employer, today's hearing is of significant interest to UPS.

The small business men and women who appeared before this subcommittee in its last hearing make a compelling case that the process by which the IRS determines who is and is not an employee is overly subjective and produces inconsistent results. Clearly, guidance is needed from Congress.

It is UPS's recommendation that any legislation voted out of this subcommittee effectively, but narrowly, target the problems of small business while addressing the broader issue, associated with worker classification on a more comprehensive basis.

Though sophisticated information technology and multi-modal transportation systems tend to define the competitive posture of our industry, labor is the key asset in the delivery of our service to the public -- and always will be. UPS serves over 200 countries with a broadranging transportation and information network that includes one of the world's 10 largest airlines, and the largest centrally fueled fleet of trucks in America. Last year, we purchased over 730 million gallons of jet and motor fuel. We own and maintain over 2,400 facilities, and utilize the only nationwide cellular network in the country. We made over \$2 billion in capital expenditures in 1995, and we expect to do so again in 1996. And despite these enormous expenditures for aircraft, fuel, facilities and technology, about 60% of our overall cost is still attributable to labor.

Why? Because, while technology can most certainly enhance the effectiveness of our workforce, it cannot replace individuals in providing our core pick-up and delivery service. Our 82,000 drivers serve every community — in fact, every address — in America. As most of the members of this subcommittee know from personal experience, our drivers are highly motivated, determined, hardworking individuals.

Experienced UPS drivers earn \$18.80 per hour, plus time and a half for overtime. With benefits they make nearly \$30 per hour. Their employment with United Parcel Service makes it possible for them to buy homes in safe neighborhoods where they can raise their children, send those children through college, cover their family's medical bills, prepare adequately for retirement, and pay their taxes. These are good jobs.

But if Congress enacts legislation without carefully examining its impact on these jobs and others like them, it could unintentionally shift the direction of our entire industry by offering huge competitive advantages to companies willing to consider replacing their employees with independent contractors.

By replacing its employees with independent contractors a business can cut its labor costs dramatically. It can do away with the need to pay overtime, unemployment insurance or workers compensation. By replacing employees with independent contractors a company can sidestep employers' responsibilities for Social Security old age, survivors and disability benefits, health benefits, and pension benefits. It can also avoid regulatory compliance requirements which are often triggered by specific threshold numbers of employees.

As an independent contractor, the former employee will enjoy fewer job protections, will probably make less money, have less medical coverage, and will be less likely to retire with a pension. Taxpayers may end up shouldering the burden for increased social welfare demands. And with such looming economic impacts, businesses would be forced to make hard choices regarding their employee-based workforce in the face of competition from very low cost providers making use of independent contractors. More liberal use of independent contractors will inevitably make employees obsolete in a variety of industry sectors.

It seems then that there must be a balance. The entrepreneurship of small business must be encouraged and nourished. The IRS needs guidance. And good jobs must not be unintentionally discriminated against by an act of Congress.

So, as a threshold matter, before legislative text is adopted, we urge that there be consensus on the fundamental criteria and on the principles involved. UPS suggests the following principles upon which legislation could be fashioned:

1) The question of whether work is contracted out to independent contractors or performed by employees of the company should be a decision which is not significantly distorted by government mandated requirements, penalties and rewards.

In a highly competitive, entrepreneurial marketplace, equity becomes crucial. Businesses that provide the same service, in the same markets must do so on a level competitive playing field. That means laws and regulations affecting economic issues, service, rates and safety must impose the same requirements on all competitors in the same industry.

2) Open and visible decision-making by IRS is needed.

When an IRS decision on employment status affects an industry and its employees, the affected parties need recourse to a process which allows them to have their views heard and considered. In short, if the government's decision will affect an industry and its jobs, it needs to be done by an open rulemaking process. The impacts of IRS decisions in this area are so fundamental to third parties, and even to other government agencies, that it cannot and should not be resolved across an audit table by the taxpayer and an IRS agent.

The IRS cannot now issue a regulation or a published revenue ruling on employment tax classification. Yet an IRS decision on employment status of one taxpayer may affect an industry and its employees. For years now, the classification of workers has been relegated to a private system of law, in which the IRS can resolve only one case at a time through audits or private rulings. If the government's decision will affect an industry and its jobs, it needs to be done on an industry wide basis with central IRS coordination and industry involvement, and it should result in published guidance that is available to everyone. Existing IRS decisions should also be reviewed and reconsidered for prospective application under this criteria.

3) The control aspect of the common law test for determining employment status needs to be retained and strengthened, not eroded.

The legal core, as I understand it, is whether the business has the right to direct and control how the worker performs the tasks undertaken. It is the cornerstone of the law and the business basis for distinguishing self-employed contractors from employees. If in fact an employer exercises, or can exercise, behavioral and financial control of how the worker performs the work, then other formalities should not prevail in the IRS's determination. Easily "gamed" aspects, like "significant costs of training", should not obscure what common law and common sense tells you is an employee.

4) Because independent contracting affects laws far beyond the tax code, corrective legislation should be comprehensive, not narrow.

Labor laws affecting benefits, hours and wage rates, discrimination, unfair labor practices, and even important parts of copyright and environmental laws, are based on employment. They do not apply (or they apply differently) to self-employed workers. A solution limited to the tax code leaves small business — our customer base — in the position of having a worker classified as independent for one law and an employee for another. Coordination and consistency are needed in the standard and in the implementation. Neither exists now.

The problems of classification go deeper than IRS processes. Until the arbitrary statutory distinctions between the treatment of independent contractors and the treatment of employees are eliminated, legislation will only cure the symptoms, not the cause.

Much of our social policy assumes an employee-employer relationship. If these assumptions are to be changed then it must be accomplished directly and comprehensively. The marketplace should not be distorted with limited exemptions. Public policy decisions that liberalize the use of independent contractors should take into account the impact on all other government and social interests.

5) Small businesses are the incubators for innovative technologies and services, and are stepping stones for economic development; their needs, resources, and challenges differ both in kind and degree from larger established businesses.

UPS picks up packages from over 1.3 million businesses a day, and delivers to many more. Most of these are small businesses. The success or failure of small business has a profound effect on UPS. Every 50 additional packages a day that small business feeds into our system, creates a new job at UPS.

The predominant problems of IRS classification center on small business. Legislative solutions should address those problems on a small business specific basis; the other issues associated with worker classification should be addressed comprehensively.

Thank you for the opportunity to testify. UPS will be pleased to provide whatever assistance would be helpful as the subcommittee proceeds on this matter.

Chairman JOHNSON. Thank you.

Mr. Pyles, Home Health Services and Staffing Association from Alexandria, Virginia, on behalf of the Coalition for Fair Worker Classification.

Mr. Pyles.

STATEMENT OF JAMES C. PYLES, COUNSEL, HOME HEALTH SERVICES AND STAFFING ASSOCIATION, ALEXANDRIA, VIRGINIA, ON BEHALF OF THE COALITION FOR FAIR WORKER CLASSIFICATION, WASHINGTON, DC

Mr. PYLES. Thank you, Madam Chairman.

I am James C. Pyles. I represent the Home Health Services and Staffing Association. We are made up of small and large businesses that provide supplemental nursing staff to health care facilities and home health care services directly to patients. HHSSA is also a member of the Coalition for Fair Worker Classification, which includes representatives of associations of large and small businesses, management and labor, who feel that legislation is needed in this area to curb the intentional abuse of the independent contractor designation.

The Coalition does not oppose the legitimate use of independent contractor status, but is opposed to the pervasive and growing practice by which some businesses ignore the law or exploit its ambiguities in order to gain a competitive advantage over law-abiding companies.

Certainly, the anecdotes of individuals that have been subjected to heavy penalties for misclassifying workers generate sympathy, but what about the concerns of the vast majority of companies that comply with the law, collect and pay employment taxes, incur other overhead costs associated with the designation of workers as employees?

For example, what about the concerns of the building service contractor in the deep South who has to lay of 4,000 workers and loses \$5 million a year to competitors who misclassify workers as independent contractors? What about the manufacturers in the garment industry in Dallas, Texas, who have been driven out of business by companies that produce clothing at cut-rate prices by using illegally classified independent contractors? What about the company that loses a multimillion-dollar government shipbuilding contract on Groton, Connecticut, because its competitor reclassifies all of its workers as independent contractors and is thereby able to submit a lower bid? What about the small supplemental medical staffing company in Parma, Ohio, that loses its principal hospital contract because a competitor offers to provide the same services through independent contractors in violation of the IRS' consistent rulings? What about the concerns of workers who are deprived of health insurance, overtime pay, protections of the child labor law, worker's compensation and unemployment laws by employers who misclassify them as independent contractors without their approval and against their will? Where do the concerns of these individuals in businesses get taken into account? These are truly what I view as the silent majority.

No one would dispute that the current test for distinguishing between employees and independent contractors is ambiguous and difficult to apply consistently. Enforcement of that law, however, is made virtually impossible by section 530 of the Revenue Act of 1978 which imposes a perverse burden of proof on the IRS, establishes safe harbors that ensure arbitrary application of the law, and forbids clarification of the definition of employee. Accordingly, this hopelessly ambiguous area of the law has not been clarified because section 530 prohibits it.

H.R. 1972 and section 582 do little to make the law more understandable and enforceable. H.R. 1972, for example, does not clarify the definition of employee or repeal section 530, but rather simply adds a definition of workers who will be deemed to not be employees. All of the ambiguities and inequities of the existing law are allowed to remain intact.

Although H.R. 1972 professes to clarify the existing law through the addition of objective standards, the criteria contained in the bill are vague and would be impossible to equitably enforce.

Further, the criteria completely ignores the issue of control which has been the core principle used in this country for over 200 years for distinguishing between employees and independent contractors.

For example, a worker could be classified as an independent contractor even though the worker's every movement was controlled by the employer if the worker paid for his own education or had school loans. This creates a novel legal concept, the totally dependent independent contractor.

Accordingly, the effect of H.R. 1972 would make the classification of most workers completely discretionary for most employers. In ef-

fect, it would say, "raise your hand if you use employees."

In addition, H.R. 1972 does not incorporate a consistency principle which appears even in section 530. Accordingly, employers would be permitted to treat some or all of their workers as employees today, independent contractors tomorrow, and employees again the next day. Such manipulation of the work force is likely since it would enable businesses to qualify for certain contracts and loans for small businesses regardless of the size of their actual work force. It also is going to be significant in who can avail themselves of a medical savings account if the Kennedy-Kassebaum bill goes through.

We also do not favor H.R. 582 because it incorporates the safe harbors of section 530 of the Internal Revenue Code and retains

the illogical and inequitable prior audit safe harbor.

A recent study performed by the accounting firm of Coopers and Lybrand concluded that misclassification of workers under the current law will cost the government approximately \$35 billion over 9 years. The cost would obviously be higher if the employment tax laws were liberalized as proposed in these bills. This kind of revenue loss is difficult to defend at a time when Congress is contemplating cutting approximately \$200 billion over 7 years from the Medicare Program.

Rather than legitimizing the abuse that is currently occurring at the cost of billions of dollars in tax revenue, we recommend a more moderate approach that still addresses the concerns identified in the White House Conference on Small Business. We recommend the approach taken in H.R. 510, a bipartisan bill sponsored by Republican Congressman Christopher Shays and Democratic Con-

gressman Tom Lantos. We believe this bill will generate moderate savings and will clarify the rules for distinguishing between employees and independent contractors in a manner that is equitable, understandable, and consistent with other Federal and State laws.

The bottom line is the approach taken by H.R. 1972 and 582 is like solving the drug problem by legalizing hard drugs. It is too radical, it is too liberal, and it is too costly.

Thank you.

[The prepared statement follows:]

HOUSE COMMITTEE ON WAYS AND MEANS SUBCOMMITTEE ON OVERSIGHT

HEARING ON EMPLOYMENT CLASSIFICATION ISSUES

JUNE 20, 1996

Submitted by: James C. Pyles, J.D.,
Counsel for the Home Health Services and Staffing Association

Madam Chairman and members of the Subcommittee, I am James C. Pyles, counsel for the Home Health Services and Staffing Association ("HHSSA"), which is an association of small and large businesses providing supplemental nursing staff to health care facilities and home health services directly to patients. HHSSA is a member of the Coalition for Fair Worker Classification, which includes representatives of associations of large and small businesses, management and labor, who feel that legislation is needed to curb the intentional abuse of the independent contractor designation. The associations that are members of the Coalition represent thousands of businesses and millions of workers nationwide.

The Coalition represents the businesses that take the trouble to determine how the employment tax laws apply to their activities and comply with the law. The Coalition does not oppose the legitimate use of the independent contractor status but is opposed to the pervasive and growing practice by which some businesses ignore the law or exploit its ambiguities in order to gain a competitive advantage over law-abiding companies.

We certainly do not favor the arbitrary enforcement of the law by the IRS, but we believe that a much greater danger to small and large business is the intentional abuse of the employment tax laws as a corporate strategy to gain a competitive advantage and maximize profits.

Certainly, the anecdotes of individuals that have been subjected to heavy penalties for misclassifying workers generate sympathy. But what about the concerns of the vast majority of companies that comply with the law, collect and pay employment taxes, and incur the other overhead costs associated with the designation of workers as employees? For example:

- 1. What about the concerns of the building service contractor in the deep South who has to lay off 4,000 workers and loses \$5 million a year to competitors who misclassify workers as independent contractors?
- What about the manufacturers in the garment industry in Dallas, Texas who have been driven out of business by companies that produce clothing at cut rate prices by using illegally classified independent contractors?
- What about the company that loses a multimillion dollar government shipbuilding contract in Groton, Connecticut because its competitor reclassifies all of its workers as independent contractors and is a thereby able to submit a lower bid?
- 4. What about the small supplemental medical staffing company in Parma, Ohio that loses its principal hospital contract because a competitor offers to provide the same services through independent contractors in violation of the IRS' consistent rulings?

5. What about the concerns of workers who are deprived of health insurance, overtime pay, and protections of the Child Labor, workmen's compensation, and unemployment compensation laws by employers who misclassify them as independent contractors without their approval or against their will?

Where do the concerns of these individuals and businesses get taken into account?

The sponsors of H.R. 1972 and 582, as well as delegates to the White House Conference on Small Business, are to be congratulated for bringing the issue of fair worker classification to the forefront of the 104th Congress' agenda. Unfortunately, however, the solutions proposed in those bills fail to address the underlying problems and, in fact, will make those problems worse.

No one would dispute that the common law test, which is required by statute to be used to distinguish between employees and independent contractors, is based on a 20 factor test which is ambiguous and difficult to apply consistently. Enforcement of that law is made virtually impossible by § 530 of the Revenue Act of 1978, which imposes a perverse burden of proof on the IRS, establishes safe harbors that ensure arbitrary application of the law, and forbids clarification of the definition of employee. Accordingly, this hopelessly ambiguous area of the law has not been clarified because § 530 forbids it.

Section 530 produces numerous anomalous results. For example, a business that has had an IRS audit for any reason since 1977 can misclassify workers with impunity forever into the future. Businesses that have misclassified workers in violation of the law and can cite examples of significant similar misclassifications among their colleagues also receive lifetime immunity. Section 530 also imposes a virtually impossible burden of proof on the IRS by establishing a presumption that an employer has a reasonable basis for not treating the worker as an employee unless the IRS can prove the negative — that no such reasonable basis exists.

H.R. 1972 and 582 do little to make the law more understandable and enforceable. H.R. 1972, for example, does not clarify the definition of employee or repeal § 530 but rather simply adds a definition of individuals who will be deemed to not be employees. All of the ambiguities and inequities of the existing law are allowed to remain intact.

Although H.R. 1972 professes to be intended to clarify the existing law through the addition of "objective" standards, the criteria contained in the bill are vague and would be impossible to equitably enforce. For example, the bill would permit workers to be classified as independent contractors if they had a "significant" investment in assets or training or had "significant" unreimbursed expenses or agreed to perform the service "for a particular amount of time." None of these key terms is defined and, with the prohibition on clarification in § 530 unrepealed, no clarifying regulations could be issued.

Further, the criteria completely ignore the issue of control which has been the core principle used in this country for over 200 years for distinguishing between employees and independent contractors. For example, a worker could be classified as an independent contractor even though the workers' every movement was controlled by the employer if the worker paid for his or her own education or had school loans. A worker under a similar degree of control could also be classified as an independent contractor if he agreed to complete a job in ten years or within his lifetime, since that would clearly be "a particular amount of time."

Accordingly, the effect of H.R. 1972 would be to make the classification of most workers completely discretionary for most employers.

In addition, H.R. 1972 does not incorporate a "consistency" principle, which appears even in § 530. Accordingly, employers would be permitted to treat some or all of their workers as employees today, as independent contractors tomorrow, and as employees again the next day. Such manipulation of the work force is likely, since it would enable businesses to qualify for certain contracts and loans as small businesses regardless of the size of their actual work force.

Even though H.R. 1972 is ostensibly directed at an issue identified by the small business community, the provisions of the bill apply equally to big business. Thus, it would appear that the bill may trigger massive reclassifications on an initial and continuing basis.

H.R. 582 is a somewhat better piece of legislation in that it is less vague and repeals § 530. We do not favor this legislation, however, because it incorporates the safe harbors of § 530 into the Internal Revenue Code and retains the illogical and inequitable "prior audit" safe harbor.

Both bills suffer from the problem that they are likely to cost the government billions of dollars in lost tax revenue. We understand that H.R. 582 has already been scored by the Joint Committee on Taxation as costing nearly \$600 million over 5 years. That amount is likely to increase to nearly \$1 billion over the 7 year planning horizon used for budgeting purposes. We believe the cost of H.R. 1972 will be much higher, because the criteria are more liberal and it contains no funding source, such as increased fines for failure to file information returns, as does H.R. 582.

A recent study performed by the accounting firm of Coopers and Lybrand concluded that misclassification of workers under the current law will cost the government approximately \$35 billion over nine years. The cost would obviously be higher if the employment tax laws were liberalized, as proposed in these bills. This kind of revenue loss is difficult to defend at a time when Congress is contemplating cutting approximately \$200 billion over 7 years from the Medicare program on which many of our nation's frait elderly depend.

Rather than legitimizing the abuse that is currently occurring at the cost of billions of dollars in tax revenue, we recommend a more moderate approach that still addresses the concerns identified at the White House Conference on Small Business. We recommend the approach taken in H.R. 510, a bipartisan bill sponsored by Republican Congressman Christopher Shays and Democratic Congressman Tom Lantos. That bill provides for the following:

- It removes the prohibition on the issuance of regulations clarifying the distinction between employees and independent contractors.
- It allows an amnesty period for employers to properly classify workers without penalty.
- It provides for notification of workers of the consequences of being classified as independent contractors so they can make informed decisions about where they work.
- It narrows the "prior audit" safe harbor to apply only in cases of prior audits that actually considered the employment tax issue.

We believe this bill will generate moderate savings and will clarify the rules for distinguishing between employees and independent contractors in a manner that is equitable, understandable, and consistent with other federal and state laws.

I would be glad to answer any questions.

Chairman JOHNSON. Thank you. Mr. Northrop.

STATEMENT OF CLYDE NORTHROP, PRESIDENT, AMERICAN ASSOCIATION OF INDEPENDENT NEWSPAPER DISTRIBUTORS

Mr. NORTHROP. Thank you, Madam Chairman and Members of the Subcommittee, for this opportunity to speak to you this afternoon.

My name is Clyde Northrop, and I represent the American Association of Independent Newspaper Distributors. The AAIND was founded 25 years ago to further the welfare and education of independent newspaper carriers and distributors throughout the United States. I personally have been an independent newspaper distributor since 1973 in the State of Maryland and currently serve as president of our association.

For over 200 years, newspaper distribution in the United States has been handled predominantly by independent carriers and distributors. In recent years, the Internal Revenue Service has begun an effort, national in scope, that could destroy this traditional means of newspaper distribution by reclassifying carriers and dis-

tributors from independent contractors to employees.

Newspaper carriers and distributors are the real mom-and-pop small businesses of our country. Many grew up delivering newspapers with their parents, their brothers, their sisters, and went into the newspaper distribution business as adults. It is not unusual to find second- or third-generation people in this very special business.

The business includes youth carriers getting their first taste of the free enterprise system, adults who deliver newspapers on a part-time basis to supplement their otherwise modest incomes, and adults who deliver newspapers on a full-time basis. These people are classic entrepreneurs.

Both carriers and distributors enjoy the ability to set their own hours, work with whom they wish, and build their individual businesses as they choose. They have always operated as independent contractors. They do not want to be employees.

They cannot understand why the IRS is attempting to put them out of business as independent contractors, even though they've fol-

lowed the rules and paid all their taxes.

These are not individuals that have lawyers and accountants on retainer. These are the smallest businesspeople that are the easiest for the IRS to intimidate.

In Kansas City, distributors refused to be intimidated when they got letters from the IRS saying that they owed extra taxes since they were wrongly classified as independent contractors and the IRS said they should have been employees.

The distributors, with the help of the newspapers Congressman Hoyer alluded to, in fact, filed some cases in U.S. Tax Court. In one of the cases, the IRS took the position that the distributor was an employee for one newspaper he delivered, but allowed him to be treated as an independent contractor for another newspaper that he had a similar contract with.

On the eve of the trial that was scheduled for May 15, 1996, actually on May 6, 1996, just a few weeks back, the IRS abruptly

dropped the cases conceding that the taxpayers in the test case and all the cases were, in fact, independent contractors. This was after more than 2 years of wasteful IRS audits and distributors threatened with financial ruin. The reclassification audit should have never been started since the IRS conceded that it didn't have a case.

The Kansas City situation is by no means an isolated situation. The IRS has challenged the independent contractor status of distributors and carriers throughout the United States. At this moment, the IRS is challenging the independent contractor status of carriers in Illinois, Florida, California, Minnesota, New Jersey, Pennsylvania, New Hampshire, Massachusetts, and Texas, and those are just the cases that our association is familiar with.

The pattern is clear. If an independent contractor or distributor alone or with the help of his newspaper can afford to hire a major law firm to sustain a legal challenge of 2 years, then, in fact, its classification will be upheld. Otherwise, he is going to be reclassified by the IRS and put out of business as an independent businessperson.

We asked for some clarification from the Congress, and fortunately in 1995, we got just that in the budget reconciliation bill.

This year, just recently, the Senate Finance Committee reported out in their small business package additional clarification language which simply states that newspaper carriers and distributors fall under the direct seller rules of the Tax Code and that they, in fact, under the direct seller rules are independent contractors.

We are calling this a clarification because it is the direct seller rules that all of the carriers and distributors in this country have operated under for the last 16 years, since there has been direct seller rules, and that the IRS has had no problem with up until 1994 when they reinterpreted their Code.

I thank the Subcommittee for your support of the Direct Seller Clarification amendment. I also thank other Members for helping us to preserve the entrepreneurial dream of newspaper carriers and distributors that independently operate their own small businesses.

Thank you.

[The prepared statement and attachments follow:]

STATEMENT OF CLYDE NORTHROP, PRESIDENT, AMERICAN ASSOCIATION OF INDEPENDENT NEWSPAPER DISTRIBUTORS

BEFORE THE HOUSE COMMITTEE ON WAYS AND MEANS

SUBCOMMITTEE ON OVERSIGHT JUNE 20, 1996

Chairwoman Johnson and Members of this Subcommittee:

My name is Clyde Northrop, President of The American Association of Independent Newspaper Distributors (AAIND). AAIND was founded to further the welfare and education of, and communication between, independent newspaper distributors and carriers throughout the United States. I also have been a newspaper distributor for 23 years. I am presenting this testimony on my own behalf and on behalf of AAIND and its members.

This testimony discusses the IRS's attempt to reclassify newspaper distributors and carriers as employees rather than independent contractors and addresses the need for legislation to clarify the status of distributors and carriers as independent contractors. AAIND strongly supports enactment of the direct seller amendment that was part of the Balanced Budget Act of 1995 which passed both Houses of Congress. That legislation would clarify that newspaper distributors and carriers can qualify as statutory independent contractors under section 3508 of the Internal Revenue Code.

IRS Challenge to Independent Contractor Status

For over two hundred years, newspaper distribution in the United States has been handled predominantly by independent distributors and carriers who now number over 600,000.

Newspaper distributors and carriers are the real "mom and pop" small business people of our country. Many grew up delivering newspapers with their parents, brothers and sisters, and went into the newspaper distribution business as adults. It is not unusual to find second and even third generation men and women in this special business.

The business includes youth carriers acquiring their first taste of the free enterprise system, adults who deliver newspapers on a part-time basis to supplement their otherwise modest incomes, and adults who deliver newspapers as a full-time business.

These people are classic entrepreneurs. Both distributors and carriers enjoy the ability to set their own hours, work with whom they wish, and build their businesses as they choose. They have always been independent contractors; they don't want to be employees. They can't understand why the IRS is taking actions against them that may put them out of business, even though they've followed the rules and paid the taxes they would owe as independent contractors.

In recent years, the IRS has begun an effort, national in scope, that could destroy this traditional means of newspaper distribution by reclassifying distributors and carriers from independent contractors to employees. At this moment, the IRS is seeking to reclassify distributors and carriers in Illinois, Texas, New Hampshire, Massachusetts, New Jersey, Pennsylvania, Florida, Minnesota, and California.

The newspaper company itself may have no exposure because it qualifies for section 530 relief under the Revenue Act of 1978, which permits the company to treat workers as independent contractors for employment tax purposes as long as it had a reasonable basis for its position and satisfies certain other tests. But section 530 does not provide any protection to the worker. Where the IRS has been stopped from collecting employment taxes at the company level because of the availability of section 530 relief, it has initiated wide-scale audits of individual newspaper distributors and carriers. In many of these cases, the distributors and carriers are mere pawns in the IRS fight to coerce the newspaper to convert its workforce to employees.

These distributors and carriers are not individuals who have lawyers and accountants on retainer. For small businessmen who deliver the paper, the prospect of an IRS audit challenging their status as an independent contractor is an intimidating experience because of the power of the IRS and the expense of defending the audit. The taxes that the IRS seeks to collect would put many distributors or carriers out of business. In reclassifying the distributor or carrier as an employee, the IRS often disallows any deduction for the distributor or carrier's substantial cash expenses of delivering the paper (gas, insurance, vehicle maintenance and supplies) and imposes an alternative minimum tax that can be confiscatory.

If the IRS asserts additional FICA tax, that tax must be paid <u>before</u> it can be contested. A small businessman generally does not have the resources to pay the tax in advance, and the IRS can seize his property to satisfy that tax.

Here are some recent examples of IRS actions that show the need for clarifying legislation:

Beginning in 1994, the local IRS offices in Kansas City began a special audit program to reclassify distributors of The Kansas City Star Company as employees rather than independent contracts. The IRS individually audited over 100 distributors during a two-year period, causing distress, distraction and disruption among the distributors who didn't know how they should file their returns in light of conflicting IRS approaches and didn't know how they would pay their tax bill if the IRS found them to be employees. At first, the IRS took the position that all distributors were employees. As the audits and the appeals process progressed, the IRS began to take the position that some distributors were employees while conceding that others were independent contractors. Without drawing any clear line, the IRS seemed to be saying that smaller distributors are employees but that larger distributors are independent contractors even though all operated under the same contracts. That left the IRS taking the anomalous position that one larger carrier was an independent contractor, but that other family members who also were distributors under similar contracts were employees simply because their routes and scale of operations were somewhat smaller. In another case, the IRS took the position that a distributor was an employee of The Kansas City Star while allowing him to be an independent contractor for another newspaper under a similar contract.

In order to end the controversy, two carriers filed test cases in the Tax Court to establish their independence and the independence of other similarly-situated distributors. Trial was scheduled to begin on May 15. On the eve of trial, the IRS conceded that the two distributors (and two additional distributors who had filed Tax Court petitions) were independent contractors. In addition, the IRS indicated that it was conceding the classification issue in all pending and open cases involving Kansas City Star distributors and that it had

terminated the special audit program to reclassify Kansas City Star distributors as employees.

The controversy ended with the right result, but look at the cost: two years of wasteful and costly IRS audits that threatened distributors with financial ruin. Those audits should never have been started since the IRS later conceded that it didn't have a case.

- In September of 1994, the IRS District Director in St. Paul, Minnesota issued a newsletter called "Tax Topics" (copy attached) which took the position that newspaper carriers who met five criteria would be treated as employees. The criteria were that the carriers were paid a specified amount for the newspapers delivered; were not involved in billing and collection; delivered the newspaper to a place specified by the customer; used their own equipment to deliver the newspaper (we always thought ownership of equipment was a strong factor in favor of independence); and did only a limited amount of work to prepare the newspaper for delivery. That newsletter was given by the IRS to local tax return preparers who were cautioned that they should not assist carriers in filing tax returns as independent contractors if they met the stated criteria. As a result, carriers found it difficult to even get assistance in filing their tax returns as independent contractors.
- In 1995, four carriers of the Rochester Post-Bulletin in Minnesota were told that they each owed back taxes and interest of thousands of dollars as a result of the IRS' determination to reclassify them as employees. If they did not have the money, the IRS told them they should consider taking a second mortgage on their homes. An IRS Appeals Officer has now upheld the reclassification. In response to the carriers' submission of a 1990 written decision of the National Labor Relations Board which held that the carriers were independent contractors, not employees, under the same legal standard being applied by the IRS, the IRS simply stated that it was not bound by and disagreed with the decision. Although the carriers presented detailed evidence in support of the twenty common law factors of independent contractor status, the IRS turned a deaf ear. For example, the carriers produced evidence that they are responsible for the payment of all expenses in connection with their delivery services, including the printing of business cards with home and car telephone numbers in the event of renewals or complaint calls from customers, and including the cost of customer gifts such as ballpoint pens advertising the distribution services of a carrier. The Appeals Officer rejected these practices as evidence of independent contractor status, stating that "[t] he purchasing of these items may be nothing more than an ego trip by the carrier." Most recently, the carriers have been told by the Appeals Officer that there is nothing that they could do to revise their relationship to make it one of independent contractor status as "it is IRS national policy" to treat them as employees. Although the IRS may disavow it, its policy in many parts of the country appears to be that newspaper distributors and carriers automatically are employees irrespective of the common law test.

Direct Seller Clarifying Legislation

The need for legislative clarification is clear. To avoid continuing conflict with the IRS and needless expense in debating whether newspaper distributors and carriers are independent contractors under the common law test, AAIND supports enactment of a provision that would clarify that newspaper distributors and carriers can qualify as independent contractors if they meet the direct seller test of section 3508 of the Internal Revenue Code as an alternative to the common law test. Congress has already once approved such an amendment as part of the budget reconciliation proposed legislation in 1995. The amendment received bipartisan support and was scored by the Joint Committee on Taxation as having a "negligible" effect on the federal budget.

Even the IRS has acknowledged that the direct seller amendment would provide needed clarification. In an October 31, 1995 letter to Senator D'Amato, Assistant Commissioner (Examination) of the IRS, L.E. Carlow, stated, "The Service recognizes that this [the independent contractor classification] is a difficult and contentious issue. We agree that, if enacted into law, the proposed legislative change to Internal Revenue Code section 3508 [the direct seller provision] will add clarification to this issue for many carriers and distributors."

There is still a pressing need for that amendment. In the absence of that clarification, the IRS will continue its attack on independent newspaper carriers and distributors across the country. Left unaddressed, the IRS may succeed in removing the opportunity for generations of small business people who want to be their own boss.

The independent newspaper carriers and distributors in this country are people who work hard daily and have followed the rules. They look to the people they have voted for all these years to correct what is unquestionably an out-of-control situation. They need this clarification now, as every month that goes by sees more carriers and distributors subject to unnecessary and costly IRS audits and the threat of being forced out of business if they are reclassified as employees.

AAIND thanks the Chair of this Subcommittee and other members of this Committee for their past support of the direct seller clarifying amendment. You are helping to preserve the entrepreneurial dream of newspaper distributors and carriers to own and independently operate their own small businesses.

For all these reasons, AAIND strongly supports the clarifying amendment that newspaper distributors and carriers may qualify as "direct seller" independent contractors.

Respectfully submitted,

Clyde Northrop



FROM THE DESK OF THE IRS DISTRICT DIRECTOR

SEPTEMBER, 1994

COMPLIANCE POLICY

The Service has taken a number of initiatives in recent years to be more responsive to taxpayers who want to voluntarily resolve their compliance problems. Such initiatives include streamlined installment agreements, closing agreements, simplified offer-in-compromise procedures, and the implementation of the non-filer program. These initiatives help taxpayers who want to comply and are in the best interest of long term compliance and the United States Government.

However, the Service does not intend that their more responsive posture towards taxpayers who are trying to comply be construed as a gignal that appropriate enforcement actions should or will not be taken when circumstances warrant.

IRS Commissioner Richardson clarified our compliance philosophy in her remarks before the meeting of the National Association of Enrolled Agents on August 26, 1993.

"An up-front approach to preventing compliance problems is the solution and I believe that the Internal Revenue Service's efforts in recent years to rethink our approach to enforcement programs have been correct. The concept of emphasizing education and information reporting to prevent noncompliance is sound. However, some have misunderstood this new emphasis to mean we will forego enforcement programs. Let me be crystal clear and assure that this is not the case! A tax system based on self-assessment would not be viable without strong civil and criminal enforcement programs to ensure compliance."

Noncompliance adversely affects everyone; each taxpayer is forced to pay a share of the taxes of those noncompliant businesses and individuals who do not pay their proper share. Roncompliant businesses have direct, unwarranted and unfair competitive advantage over their compliance counterparts. Enforcement action will be taken promptly in accordance with Internal Revenue Manual guidelines against taxpayers who have not shown a good faith effort to comply voluntarily. Timely actions in our interventions with taxpayers is a major factor in ensuring compliance.

St. Paul District Tax Topics

The Service is strongly committed to the success of the Electronic Filing Program and its continued growth. Seminar topics will include 1995 changes, 1040PC and Electronic/Magnetic Media filing of business returns (940, 941, 1041, 1120-A(PC), 5500 series). In addition to the format above, which is geared to the experienced filers, two seminars will be specifically held for new filers. The application process, shopping for software, equipment needs, suitability, testing procedures, balance due, and direct deposit will be covered in a much greater detail, as well as the above subjects held for experienced filers. All current applicants will automatically receive an invitation, as well as anybody contacting our office asking to be placed on the mailing list.

You will see many changes this year with the program. The Service will begin a strong marketing approach to educating the public and encouraging individuals to ask for "Electronic Filing". Some alternatives include filing from your home computer, expansion at volunteer sites (YITA/TCE). IRS offices, and employers offering this service to their employees. Due to many pending changes, including asynchronous or standard modem filing, there will be no July update of Pub. 1345, Electronic Filing Handbook: Be sure to attend one of the scheduled seminars to plan a successful year before the December revision is distributed. For information about any of the above topics, you may contact Hichelle Benson, District Electronic Filing Coordinator, at (612) 290-3379.

Date	Time	Location
- September 27	8:30 - 11:00 a.m.	St. Paul Galtfer Plaza
* September 27	12:00 - 3:00 p.m.	MM Dept. of Revenue Bldg.
October 4	9:00 - 11:30 a.m.	Hennepin Tech. College Brooklyn Park
** October 5	9:00 - 12:00 noon	Normandale/Pentagon Park
	8:00 a.m 1:00 p.m.	Exhibitors
October 6	9:00 - 11:30 a.m.	Duluth Technical College
October 11	9:00 - 11:30 a.m.	MM Riverland Tech College
OCCORN II	, 11.uu 1	Rochester
October 13	9:00 - 11:30 a.m.	St. Cloud Tech College
October 14	9:00 - 11:30 a.m.	South Central Tech
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^{**} For new participants
** For new participants, exhibitors will also be present from
8:00 a.m. - 1:00 p.m.

ENPLOYMENT STATUS REQUESTS

The St. Paul District has received a number of requests for a determination of the employment status of adult devspaper carriers. These

St. Paul District Tax Topics

carriers:

- were paid a specified amount directly by the newspaper for each newspaper delivered,
- * were not involved in the collection process (the billing and collection process was done through the newspaper office).
- * delivered the newspaper to the individual customers either by placing the newspaper in a newspaper holder near the customer's residence or by placing the newspaper near the front door of the customer (or a similar place specified by the customer),
- " used their own transportation to deliver the newspaper, and
- did only a limited amount of work to prepare the newspaper for delivery, such as place the newspaper in a plastic bag, wrap it in a rubber band, or place advertising inserts in certain issues of the newspaper.

If the newspaper carrier meets the above criteria, the Internal Revenue Service has determined that the carrier is an employee of the newspaper, as defined by Internal Revenue Code Section 3121(d)(2). However, even though we have determined that these delivery people are employees for the purpose of Federal taxes, the newspaper may not be required to treat these carriers as employees because it has an exemption from doing so under Section 530 of the Revenue Act of 1979. Because of this exemption, the newspaper is not required to withhold Federal income tax or deduct Social Security Tax, and it is not required to issue a Form W-2. Rather, it issues a Form 1099-Misc. These employees should report their delivery income and related expenses as follows:

- Report the amount shown in Box 7 of the Form 1099-Misc. on Line 7 of the 1993 Form 1040;
- Complete a Form 4137 and report the employee's share of the Social Security tax on Line 50 of Form 1040 (you need to alter this form slightly - cross out "Tip Income" at the top of the form and write in "Wages"), and
- 3, Claim any related delivery expenses on Form 2106. Expenses which are allowed after completing Form 2106 are transferred to Line 19 of the Schedule A and are subject to a 2% limitation based on adjusted gross income.

If you have any questions on how to complete the forms properly, please call our Taxpayer Service Division at 644-7515, toll free at 1-800-829-1040 or toll free for hearing impaired at 1-800-829-4059.

Chairman JOHNSON. Thank you very much. Your examples were very powerful.

Mr. Phillips.

STATEMENT OF LOCKWOOD PHILLIPS, ASSOCIATE PUBLISHER, CARTERET COUNTY NEWS-TIMES, MOREHEAD CITY, NORTH CAROLINA, ON BEHALF OF THE NATIONAL NEWSPAPER ASSOCIATION

Mr. PHILLIPS. Thank you, Madam Chairman.

I appreciate this opportunity to speak with you today, but reflecting on the remarks made just moments ago by Mr. Northrop, I must also confess to you that I am fearful of being here today because my presence in this hearing definitely raises my profile as

a taxpayer.

While I and my staff take great care to pay all taxes and classify our staff properly, the current case history of audits and compliance checks in the newspaper industry leads me to conclude that aggressive audits, similar to those details in my written reports to you, my written comments, and also, those of Mr. Northrop would be onerous and financially destructive to me and my business and my employees.

In most cases, these arbitrary aggressive and harassing audits are requiring tens and hundreds and thousands of dollars to right, in spite of the historical precedence that independent contractors have served the newspaper industry, and it is interesting to note that section 530 provides safe harbor for independent contractor

status applying to conditions existing since 1978.

According to my records, we have been in the business of newspapering since approximately 1778. So, therefore, you would think that we would fall under the Safe Harbor Act of section 530. That does not seem to be the case, as detailed in my comments, but let me just digress for a moment and tell you who I am.

I am the owner, along with my brother, of a triweekly, started as a weekly on the coast of North Carolina. It has grown from 5 employees to 60 employees. It is a family enterprise begun by our

parents.

We have grown from 5 little merchants to 20 independent adult carriers. If we were to face the financial burden brought on by the demands and penalties being levied in our industry, we do not have a large enough experienced legal staff, such as those provided to the Washington Post or the New York Times, to fight such an audit or compliance check. We are a small newspaper providing local news, doing what larger papers have no interest in doing. We pay our taxes and file Form 1099 forms as required. We have neither the time, the money, or interest in avoiding our responsibilities by esoteric and imagined defilings. All we want to do is run a good newspaper, and in the process provide a voice and forum for our community, and through the circulation of our paper a chance for independent contractors and carriers to earn money.

Carriers of country correspondence are the people that are making a living from our enterprise. Who are these independent contractors, you may ask. They are entrepreneurs. They are high school students. They are mothers who want to stay home with their children, but want to supplement their family income. They

are retirees who are bored and want something to do to get out of the house, to make contact with others, and they are the Roy Cannons of the world, who as a teenager contracted polio, permanently crippling him and making it almost impossible to get a job in a small coastal community like Morehead City.

While he lacked the physical skills to succeed in the normal business environment, he had the courage, spirit, and mental ability to start a route in an area not serviced by any of our carriers, creating the single-largest route both geographically and in the number

of customers served.

We are a small enterprise. We are attempting to provide business for others. We are growing. We have no interest in avoiding our responsibilities or our taxes. All we are asking for is clear definitive steps for classifying our staff.

As far as hiring independent contractors versus employees, we would much prefer to have employees especially in technical trades. They are people we would have control over and direction with.

In the case of carriers, it makes good sense, common sense. They are working on an average of 9 hours a week. There is no reason for them to be employees. They couldn't qualify as full-time employees.

I would like to just conclude by saying that we believe that the Christensen bill, H.R. 1972, is an excellent starting point for resolving our concerns. However, to resolve our current concerns, any

legislation should solve the following three elements.

We need to discuss the issue of compensation per piece per unit. While some carriers do contract on a commission basis, there are many others that are paid on a flat fee, significant new investment including equipment. A newspaper carrier's investment usually includes primarily their cars that enables them to do their job, be it a car or a bicycle. For a photographer, it is his or her photographic equipment and studio.

Then, last, the requirement to have fixed facilities, we feel that to have a fixed facility is unreasonable and it is onerous and, in many instances, impossible, as was discussed in the previous panel.

Thank you very much for listening to my comments. [The prepared statement and attachments follow:]

TESTIMONY OF LOCKWOOD PHILLIPS PUBLISHER OF THE CARTERET COUNTY NEWS-TIMES MOREHEAD CITY, NORTH CAROLINA ON BEHALF OF THE NATIONAL NEWSPAPER ASSOCIATION BEFORE THE HOUSE SUBCOMMITTEE ON OVERSIGHT JUNE 20, 1996

Introduction

I want to thank Chairman Nancy Johnson and other members of the House Ways and Means Subcommittee for Oversight for granting me the opportunity to present the community newspaper view of the independent contractor problem on behalf of the National Newspaper Association. I am the publisher and manager of the Carteret County News-Times, in Morehead City, North Carolina. I am also a member of the Board of Directors of the National Newspaper Association.

The National Newspaper Association was established in 1885 and has more than 4,000 community newspapers as members. These include most of the weeklies and more than one-third of the daily newspapers in the country with a focus upon newspapers serving smaller markets and communities. Most of our 4,000 members utilize independent contractors to carry out tasks that cannot be handled by employees. These contractors include newspaper carriers, stringers, "country correspondents," photographers, and others whose work is developed upon an arms' length agreement with the publisher. The IRS is targeting newspapers in an effort to change the long-standing industry tradition of contractor work.

At the outset, I want to stress to the Subcommittee that we are seeking to clarify what we believe is an already existing relationship. Our goal is not to reclassify employees as contractors any more than to reclassify contractors as employees. The issue is that a newspaper as a business in a local community, and an independent contractor as a local entrepreneur are each doing their best to follow the obscure common law 20-factor test and to demonstrate the validity of this industry tradition. Despite this, the IRS is still pursuing our industry with zeal. The IRS has not provided guidance and has instead pursued newspapers and sometimes the contractors themselves on a "gotcha" basis with virtually no bright line for us to follow. Our best option is to seek Congressional action to ensure the IRS has rules that are easy to follow and hard to misinterpret by local auditors.

Independent Contractors in the Community Newspaper Business

Allow me to first focus on the IRS's pursuit of newspaper carriers. Many Members of Congress probably had their start in business as newspaper carriers. The time honored "Junior Merchant" program lives on today. But today, newspaper carriers are more often adults. These adults, who are independent businesspersons, are being unfairly targeted by the IRS. The typical newspaper carrier is a classic entrepreneur -- a business person -- not an employee. He or she operates as a business, delivers newspapers on route by contract, files taxes as a business and offers services to a variety of customers. However, the carrier business is threatened by rampant and subjective IRS enforcement. As Daniel Webster said before the Supreme Court in 1819, "An unlimited power to tax necessarily involves the power to destroy." McCulloch v. Maryland, 4 Wheaton 316 (1819).

There are other independent contractors utilized by community newspapers. These contractors include writers who serve as stringers or freelancers, sometimes called "country correspondents." A country correspondent can be invaluable to a small town. Due to economic factors, several small towns may be covered by a single newspaper. The residents of each of the small towns around us want to read about local events, so the closest newspaper will seek out a local correspondent who lives in that community to cover local events and who is plugged into the heart of that community. The country correspondent or stringer is usually compensated on a per piece basis, or per story basis-- not at an hourly rate. If there is no news, the stringer doesn't work and the paper doesn't carry an unneeded expense.

Newspapers also will contract with photographers. Photographers in a local community may do wedding portraits, cover local news events, and may offer their services to a variety of customers. Again, a newspaper will compensate the photographer on a per piece or per

photograph basis. There are also other independent contractors such as cartoonists, who may serve as free-lance artists for a variety of customers in a small community, and various delivery or production-related workers, such as desktop publishers who prefer to work at home and do layout on a contract basis.

It is important to understand that these individuals are entrepreneurs who are not interested in a typical, nine-to-five job working for one employer. They want their independence, they want the ability to set their own hours. Some may have family needs to consider or may be retired and are supplementing their retirement income. Others, by the very nature of their duties cannot work for a single employer such as the carrier who delivers several competing products.

We applaud the Subcommittee's efforts to find a solution to a problem that affects nearly every small business in America and is of vital importance to our members. We would like to work with your Subcommittee to find a resolution to the tangled web of IRS interpretations and regulations regarding the definition of an independent contractor and make it clear what the IRS chooses not to see: that the typical independent contractor is a classic entrepreneur -- a business person -- not an employee.

We also wish to stress the importance and value of the small newspaper that may often be the only information provider for America's heartland. Many community newspapers are operating on the thin edge of financial survival. Layers of subjective interpretations and burdensome regulations issued by the IRS regarding independent contractor status will force these important independent voices of America's local community into silence.

Community Newspapers and the Small Town

Allow me to elaborate. In a small town like Morehead City, North Carolina, where I am from, contractors are vital to the economy and to the financial strength of local newspapers.

These are small communities where everyone knows each other by their first name. Imagine you live in a house in the middle of a small town. You may receive your community weekly delivered by one carrier, a community daily by another carrier, and a weekly shopper by another, and even a metropolitan daily from a nearby city or the Wall Street Journal by still another. You also may occasionally get flowers and dry cleaning delivered by someone else. Delivery services make small town life possible, but more importantly, they offer a livelihood to its citizens. Many times there are no large companies offering full-time employment, so you yourself work part-time at the local bookstore, you fix chimneys and deliver wood during the winter, and you take pictures of local events and sell them to the local daily paper for extra money. You may even deliver the Saturday edition. You enjoy living in your small town for the sense of community and the peaceful surroundings. You have made the choice not to seek fortune and fame in a large city. You enjoy the independence of running your own business and you get by, just as many of the small businesses in your town do.

Suddenly, you face a hefty IRS assessment for failing to pay income taxes. The IRS has decided your business isn't really a business and wants you to pay for multiple sins on your tax form. How will you pay? How will this affect your local newspaper since it cannot rely on you to deliver its Saturday edition anymore? The newspaper can also face heavy fines and penalties -- perhaps heavy enough to drive it out of business. What will happen to your community without its newspaper?

IRS Actions Against Newspapers

Let me give you some examples. Recently, the IRS targeted a newspaper carrier, a man at the end of his working career, with an audit of his business expenses. He was assessed nearly \$10,000 in back taxes for the previous three years, a period when the IRS claimed that the carrier was an employee and that certain expenses were not deductible. Yet the newspaper he delivered, Rochester Post Bulletin (MN), had written contracts and followed not only what it thought were IRS rules, but was careful to avoid exercising control over delivery. It appropriately filed 1099's for the carriers as the IRS requires. It treated the carriers in all instances as contractors. The IRS denied the independent contractor status because, among other things, it found that some subscribers pay for their subscriptions at the office, rather than directly to the carrier.

Despite the fact that the carrier was clearly compensated on a contract basis and behaved in all respects as an independent business, the IRS chose to see an employee there and determined the payment arrangement overrode the other factors. Newspapers frequently have Pay in Advance (PIA) systems, or permit payments to be mailed to the company directly, but carriers are still paid on a per-piece basis or on a flat-rate basis, not by a salary or hourly wage. These carriers operate in true independent fashion. Many in fact deliver a daily paper and then go out again to deliver a competing weekly, something no employee could do.

Another example comes out of Washington, Pennsylvania. In 1993, the controller of the morning Observer Reporter received a call from an IRS agent stating the paper's federal employment tax returns, Forms 940 and 941, had been assigned to him for review. In a follow-up letter, he asked the controller to provide photocopies of the following documents for the tax year 1992: form 1120; Forms W-2, W-2C, W-3, W-3C, W-4, and UC2; contracts between businesses and independent contractors; Forms 941, 1099, 1096; invoices from independent contractors; general-ledger pages; cash-disbursements journal; form 1099 payment journal; and canceled checks.

The newspaper's controller and general manager met with the IRS agent for several hours. Before leaving, the agent told them he was going to classify 50 motor carriers as employees. In the past several years, the newspaper's top managers, accountants, and tax lawyers have spent hundreds of hours struggling with its outcome. Last year, the IRS appeals officer presented the newspaper with a bill for \$60,000 for one year and promised it a "safe harbor." As I am sure the Subcommittee knows, the "safe harbor" generally speaking, since I am not a lawyer, grants the newspaper an exemption from employment taxes if the newspaper has a "reasonable basis" for doing so. A reasonable basis includes a "long-standing practice of a significant segment of the industry," such as newspaper carriers. A \$60,000 harbor is a pretty costly one, something most community newspapers could never afford. The matter is still unresolved after three years. The publisher of the newspaper has detailed his impression of this experience in a letter to the Subcommittee, which I attach to my written testimony.

A third example comes from yet another newspaper in Minnesota, which asked not to be named, as its carrier has been intimidated by the IRS. In this case, the carrier was delivering not only a daily newspaper and a weekly newspaper, but materials for a local bank. He was following the rules, he thought, and the newspapers thought they were also following the rules. Yet his contractor status was denied, and he was ordered to pay \$3,000 in back taxes. Among the grounds of denial was the assertion that he did not participate in the making of the product he was delivering. Presumably, the IRS believes a contractor who delivers cake for a bakery must also bake the cake. We find this example absurd -- particularly after we learned the person's status as an independent contractor for the bank was allowed, even as his status as a paper carrier was denied. We can only assume he was not printing the money he delivered. You can understand why we believe we are being targeted.

There are many such examples that are a result of the IRS 's subjective rules on the differences between an independent contractor and an employee, applied arbitrarily. Even the IRS admits it can draw no bright line between a contractor and an employee. If the taxing agency cannot explain the rules, how can a common citizen follow them?

Currently, the IRS follows a 20-factor test based on common law to determine whether a company exercises sufficient control over a service provider to establish an employee-employer relationship.

Now I am not going to take up your time to list these factors, but let's just say they have led to uneven enforcement, at best. Are these separate factors? Are they to be taken as a whole? Does an IRS agent pick and choose which factor to apply? A small business is required to hire a team of attorneys and accountants to figure out the safest approach in dealing with contractors. I don't know of any small business that can afford to do this. Despite a plethora of seminars and workshops to help us as newspaper publishers to figure out what we must do, many of us live in fear of the IRS's power to destroy. What has happened to the time-honored test of lack of control which served this legal question well until recent years? One supposed saving clause is the "safe harbor," but even it comes at a price, as our Pennsylvania colleague found. And it is often a mixed blessing, leading to unanticipated effects in the business.

Even with this safe harbor, the IRS is still pursuing newspapers. As one newspaper attorney said, "It's very simple. They (IRS) adopt a scorched earth policy. They've never met an independent contractor -- they're all employees." Our experts tell us that in about nine out of 10 cases, the IRS finds persons classified as independent contractors should be reclassified as employees. Since about 90% of all daily newspapers and many weekly newspapers use independent contractors to sell or distribute newspapers to home delivery subscribers, it makes a fat target for the IRS.

Has the IRS made any attempt to rectify this situation? Last year, Margaret Milner Richardson, the Commissioner of the Internal Revenue Service, testifying before the House Committee on Small Business, said that the IRS plans to develop training materials for the IRS examiners handling worker classification issues that emphasize that using independent contractors can be a legitimate business practice that will not be challenged by the IRS.

When the first draft of "guidelines" was released, it was over 100 pages long. How is a small newspaper publisher supposed to take time out to try to figure out if he/she is in compliance if the IRS itself needs over 100+ pages to do so? We are also dismayed at the IRS's attempts to settle claims after threatening costly litigation despite the fact that the accused taxpayer may have been following the IRS's own decision in a previous audit. The cost of defense is so imposing that settlements are often cheaper - and that is what the agency intends to convey, I believe.

Congress Needs To Take Immediate Action

Congress has not taken significant action to resolve this problem since 1978.

Additionally, as far as I understand it, the safe harbor, Section 530, was enacted to provide temporary relief until Congress came up with a new test for independent contractors. But as I've stated, even the safe harbor is being chipped away by the IRS.

There are several legislative proposals before Congress at this time. Regardless of the specifics of these proposals, we believe it is time for Congress to take control of the situation and make certain the IRS is objective and fair in its actions against small businesses. A clear test for independent contractor status will go far in this respect.

We believe the Christensen bill, H.R. 1972, is an excellent starting point for resolving our concerns. It properly begins to define that all-important bright line to resolve the current uncertainty, discourage rampant harassment of taxpayers and recognize the legitimacy of independent contractors. However, to resolve our concerns, any legislative solution needs to have the following three key elements:

- 1. Compensation per piece or per unit: While some carrier contractors may be paid on a commission basis, most are paid on a flat fee basis or on a per piece basis. We are concerned about covering this method of compensation in the bill.
- 2. Significant investment includes equipment: A newspaper carrier's significant investment -- the very tool that enables him to do his job -- is his vehicle. For a photographer, it is his/her photographic equipment and studio, for the correspondent, it may be their computer. From these viewpoints, such investments are very significant and legislation should recognize its significance. The significance of an investment should be measured against the contractor's capacity, not by an arbitrary measurement.
- 3. No need for a fixed facility: The criterion for maintaining "a principal place of business" would be a problem for many delivery people, especially since the IRS has ruled that the newspaper's delivery area belongs to that newspaper. Their place of business is their car, in most cases, and there is no need for any more fixed facility.

These key elements are present in S. 1610, the independent contractor bill introduced by Senator Don Nickles and Senator Christopher Bond. NNA fully endorses S. 1610 as a good solution.

We would like to emphasize that newspapers typically are zealous in complying with IRS rules as we traditionally understood them. Writing good contracts, filing 1099 forms and adhering to the rules of control have been the subject of many training sessions for newspapers. Encouraging contractors to develop other business -- particularly delivery business -- is something that is almost second nature.

We are diligent taxpayers. In fact, the newspaper business is one of the largest taxpayers, collectively, of any industry in the United States. In this case, we are simply being harassed, and even more sadly, our carriers are being harassed. The community newspaper and its contractors are among those least able to withstand the grueling test of litigation the IRS often forces upon us. As I mentioned earlier, the community newspaper often operates on thin margins. Ours are not the fat cats of the industry. The papers are usually owner-operated and they face many of the same threats of extinction facing the family farm. Litigation threatens the newspaper's survival and the survival of the community's only independent voice.

Conclusion

We applaud the Subcommittee for its efforts in taking on a terribly important problem. The National Newspaper Association looks forward to working with you to further develop the legislation to bring clarity to what is now a very confusing and threatening situation. We want to make plain what the IRS chooses not to see: that the typical independent contractor is a classic entrepreneur, a business person, not an employee. Contractors are critical to community newspapers and their customers. It is not an exaggeration to say they hold together small communities like Morehead City, North Carolina together. Thank you.

OBSERVER PUBLISHING COMPANY

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Observer & Reporter

SERVING WASHINGTON AND GREENE AREA

June 17, 1996 House Ways and Means' Subcommittee on Oversight Chairman, Nancy Johnson

As I wrote last July to the House Committee on Small Business' Subcommittee on Taxation and Finance, " The 1993 audit of independent contractors was unlike any audit we have had before. In the year that has ensued, I haven't changed my opinion.

As the issue drags into its third year, there's every indication we will be left with the alternative of accepting an unsatisfactory resolution costing "only" \$20,000 in attorney's fees; or, face a six figure legal bill defending what has been a basic industry practice that, in our opinion, clearly meets the 20 point test for determining independent contractor status.

It's not unlike the protection racket except the payoff isn't money. It's blind obedience to whim, fancy and internal and external politics, of the Internal Revenue Service. The penalty, of course, is possible fines, penalties, interest and back taxes; expensive legal fees; and/or harassment and continual vulnerability. I call it wrestling the gorilla.

Let me insert that I have been in this business for over 40 years and my family in it for 94. Our relations with the IRS, both corporately and privately, have never been acrimonious or without mutual respect. The 1993 independent contractor audit, apparently a part of a nation wide attack on small businesses, was the converse of that.

Point by point:

1. Although we provided extensive documentation and records about our independent contractors, the auditing agent spent a surprising short time in our office. It was obvious he had predetermined his audit.

2. Subsequent meetings with our staff and our own auditors reinforced this first impression. The 20 point test, including

industry practice, was no longer applicable.

1. The auditor declared that if we sought section 530 relief based on a prior audit we would have to admit that everyone involved was an employe. The IRS since then has done an about face.

4. We were told that the service might write letters to our independent contractors informing them that the service considers them employes.

5. It was hinted that our independent drivers might be

audited. We provide them with a 1099, by the way.

6. Subsequent discussions with other publishers who were

6. Subsequent discussions with other publishers who were targeted revealed similar patterns.

Obviously the service doesn't have to concern itself with customer relations, sensitivity, fair practices, respect, and so forth. Regulations that apply to bill collecting in the private sector obviously don't apply here, though it is difficult to understand why not.

That's about it Thanks for reading and listening.

That's about it. Thanks for reading and listening.

Sincerely, Worthof

W.B. Northrop co-publisher June 18, 1996

Daily Herald

The Honorable Nancy Johnson Chairwoman, Subcommittee on Oversight Ways and Means Committee House of Representatives Washington, D.C. 20515

DANIEL E. BAUMANN, President

Dear Chairwoman Johnson:

I understand your committee is reviewing the impact of IRS treatment of independent contractors on small business, and I want the committee to be aware of our experience. It is an example of bureaucratic rulemaking harshness and inconsistency that could threaten the existence of one of a dwindling number of family-owned newspapers left in the United States.

Several years ago we decided to convert our delivery system from youth to adult carriers. The two metropolitan dailies we compete with use adults, and they were able to deliver to their customers an hour or more before our papers arrived. To deliver at a competitive hour, we needed to use adults.

We are family-owned, and we chose not to fire our youth carriers. Rather, we replaced them with adults as the youths left their routes. For more than a year, we operated two delivery systems, at great expense, simply out of loyalty to our youth carriers.

Because we exercised heavy control over the interim adult carriers, we did not believe they qualified under the IRS 20-factors test. Therefore, we treated these interim carriers as employees. Once the conversion was completed, we initiated contracts similar to those used throughout the newspaper industry, and we treated the carriers as independent contractors.

Despite our carefully designed contract, the IRS agent who visited us in 1994 determined that our carriers did not qualify on "status" as independent contractors. He indicated other newspapers treating carriers in an identical fashion would be given Section 530 relief. However, because we had treated the interim carrier force as employees, he said we did not qualify for that form of relief either. If we had brazenly misclassified our interim carriers as independent contractors, we now would have a "pass" from the IRS!

Paddock Publications, Inc. Post Office Box 280 Artington Meighes, Illinois 60006 Telephone 847-427-4300 Fax 847-427-1550 The Honorable Nancy Johnson - June 18, 1996 - Page 2

For trying to do the right thing, we must be punished. And punished:

The agent assessed us for taxes on the amounts paid to the interim carriers. He next imposed a 10 percent fine for "failure to deposit." He added a 20 percent penalty claiming we had acted in reckless disregard of our tax liability, despite the fact that we had filed 1099 forms on all these individuals. In all he assessed us \$5.6 million for two tax years.

We simply cannot afford to pay an assessment like that, and we cannot afford on an ongoing basis to operate with employee carriers when our huge metropolitan competitors are allowed to treat their carriers as independent contractors.

Our IRS appeals officer has been unwilling to concede either on status or on Section 530 relief. Our only options appear to be to settle or take the U.S. government to court. We believe the IRS is counting on the exposure of \$5.6 million to scare us into a settlement that will place us at a permanent competitive disadvantage.

We are pleased the subcommittee is considering legislation to rectify situations such as this; the IRS clearly needs to be brought under decent control. We believe the approach that will address our problem, and best meet the newspaper industry's need, is the Senate version, S. 1610.

Sincerely,

Daniel E. Baumann

Danil & Bauman

Chairman JOHNSON. Thank you for your comments.

Leonard Doctor, president of the National Association of State Farm Agents.

STATEMENT OF LEONARD DOCTOR, PRESIDENT, NATIONAL ASSOCIATION OF STATE FARM AGENTS

Mr. DOCTOR. Madam Chairman and Members of the Subcommittee, which Mr.—oh, we have more than one now. OK. Thank you for the opportunity to appear before you today to discuss the independent contractor issue.

My name is Leonard Doctor. I am president of the National Association of State Farm Agents, NASFA, and vice president of

the Coalition of Exclusive Agent Associations, CEAA.

NASFA is a 23-year-old national organization which represents State Farm Insurance exclusive agents across the country. The CEAA is a national umbrella association made up of member associations which represent agents of State Farm, American Family, Farm Bureau, Minnesota MSI, Nationwide, and Allstate. These member associations draw their individual agent memberships from over 60,000 captive, exclusive, multi-line agents who serve over 65 percent of America's personalized insurance needs.

We are here today to support the efforts of Congressman Christensen and others to simplify the tax treatment of independent contractors, but also, to raise a critical issue which needs to be addressed in any such legislative initiative, including Congressman

Christensen's bill, H.R. 1972.

We firmly believe that any legislation in this area should support the self-evident axiom that independent contractors be treated as truly independent. H.R. 1972 and other similar legislation must be changed to make clear that it will not allow businesses to exercise employee-like controls over agents or other independent contractors nor create other tax opportunities for control.

While these businesses at the same time treat service providers as independent contractors for Federal tax purposes, H.R. 1972 would make it easier for businesses to classify workers as independent contractors for tax purposes.

Importantly, however, these bills that are currently drafted may result in significant adverse non-tax consequences for exclusive

insurance agents and others.

Under these bills, a worker can be classified as an independent contractor by meeting three simple tests, including a test which would require a written contract stipulating that the worker will not be treated as an employee for tax purposes. Once met, section 530 relief and the 20-factor test become moot.

In the case of exclusive insurance agents, these tests could be met and classification as an independent contractor would occur merely by showing that agents are: One, paid primarily on a commission basis; two, pay fair market rent for their facilities; and three, have a written contract that provides that agents will not be treated as employees for tax purposes.

By making it so easy to meet the independent contractor tax standard, H.R. 1972 would allow businesses to impose additional significant non-tax employee-like controls on workers without running afoul of the tax laws. For example, businesses could put man-

dates in time, place, and method of business operations, and exercise controls over daily business operations, all without violating the tax standard.

Clearly, these unilateral controls would negatively impact the independence of agents throughout the country. Exclusive insurance agents support the intent of H.R. 1972 to simplify tax treatment of independent contractors, but once change is made to treat independent contractors as truly independent for their business operations, the bill should make clear that it will not allow businesses to exercise employee-like controls over exclusive agents or other independent contractors, nor create other non-tax opportunities for control over such service providers while at the same time enjoying favorable treatment under the Tax Code. This simple goal can be accomplished by amending the written contract test of H.R. 1972 to require that a worker be guaranteed independence and not be treated as an employee for all purposes, both tax and non-tax purposes. This change will recognize the true independence of exclusive insurance agents.

In conclusion, we support the efforts of Congressman Christensen and others to simplify the tax treatment of independent contractors, but urge Congress to modify H.R. 1972 to ensure that independent contractors remain truly independent for both tax and

non-tax purposes.

Both NASFA and CEAA stand ready to work with you, Mrs. Johnson, Mr. Kleczka, Mr. Hancock, the Members of this Subcommittee and your staffs to ensure fair treatment of exclusive agents, and I thank you for giving me the opportunity to be here today and to express our views on this important bill.

[The prepared statement follows:]

STATEMENT OF LEONARD DOCTOR OF THE NATIONAL ASSOCIATION OF STATE FARM AGENTS

' Madame Chairwoman, Members of the Subcommittee, thank you for the opportunity to appear before you today to discuss the independent contractor issue. My name is Len Doctor. I am President of the National Association of State Farm Agents (NASFA) and Executive Vice President of the Coalition of Exclusive Agent Associations (CEAA).

NASFA is a 23 year old National organization which represents State Farm Insurance exclusive agents across the country. The CEAA is a National umbrella association made up of member associations which represent agents of State Farm, American Family, Farm Bureau, Minnesota MSI, Nationwide, and Allstate. These member associations draw their individual agent membership from over 60,000 captive, exclusive, multi-line agents who serve over 65% of America's personal lines insurance needs.

I. EXECUTIVE SUMMARY

We are here today to support the efforts of Congressman Christensen and others to simplify the tax treatment of independent contractors but also to raise a critical issue which needs to be addressed in any such legislative initiative, including Congressman Christensen's bill, H.R. 1972. We firmly believe that any legislation in this area should support the self-evident axiom that "independent contractors" be treated as truly_independent. H.R. 1972 and other similar legislation must be changed to make clear that it will not allow businesses to exercise "employee-like" controls over agents or other independent contractors, nor create other non-tax opportunities for control; while these businesses at the same time treat such service providers as independent contractors for Federal tax purposes.

II. BACKGROUND

Most "exclusive agents" support being treated as independent contractors for tax and other purposes. At present, this tax treatment is achieved under the "Section 530" safe harbor and the "20 factor test." Please note that this treatment is separate and apart from the special statutory exceptions for the life insurance salesforce currently existing under Section 3121(d) of the Internal Revenue Code.

The Section 530 safe harbor was intended to provide relief to service recipients if they have a reasonable basis for their classification of a service provider as an independent contractor. Without this safe harbor, the "20 factor test" would apply to determine if a service provider should be treated as an independent contractor for Federal tax purposes. To the extent "employee-like" controls are imposed, treatment of service providers as independent contractors for Federal tax purposes is jeopardized. This has the result of maintaining practical independence for service providers who are intended to be treated as "independent contractors" for Federal tax purposes. Such service providers, thus, remain truly independent for both tax and non-tax purposes.

III. H.R. 1972 AND SIMILAR LEGISLATIVE EFFORTS

H.R. 1972 on the House side, and S. 1610 on the Senate side, would make it easier for businesses to classify workers as independent contractors for tax purposes. Importantly, however, these bills as currently drafted may result in significant adverse non-tax consequences for exclusive insurance agents and others.

Under these bills, a worker can be classified as an independent contractor by meeting three simple tests, including a test which would require a written contract stipulating that the worker will not be treated as an employee for tax purposes. Once met. Section 530 relief and the "20 factor test" become irrelevant.

In the case of exclusive insurance agents these tests could be met and classification as an independent contractor would occur merely by showing that agents are: (1) paid primarily on a commission basis; (2) pay fair market rent for their facilities; and (3) have a written contract that provides that the agents will not be treated as employees for tax purposes.

While easier classification as an independent contractor for tax purposes is desirable, it can have unintended non-tax consequences. By making it so easy to meet the independent contractor tax standard, H.R. 1972 would allow businesses to impose additional significant non-tax "employee-like" controls on workers without running afoul of the tax laws. Importantly, for example, businesses could put mandates on time, place and method of business operations; and exercise controls over daily business operations; all without violating the tax standard. Clearly, these unilateral controls would negatively impact the independence of agents throughout the country.

Exclusive insurance agents support the intent of H.R. 1972 to simplify tax treatment of independent contractors, but want changes made to treat independent contractors as truly independent in their business operations. The bill should make clear that it will not allow businesses to exercise "employee-like" controls over exclusive agents or other independent contractors, nor create other non-tax opportunities for control over such service providers, while at the same time enjoying favorable treatment under the tax code.

This simple goal can be accomplished by amending the written contract test of H.R. 1972 to require that "a worker will be guaranteed independence and not be treated as an employee for all purposes (both tax and non-tax purposes)." This change will recognize the true independence of exclusive insurance agents.

IV. CONCLUSION

We support the efforts of Congressman Christensen and others to simplify the tax treatment of independent contractors but urge Congress to modify H.R. 1972 and other similar legislation to ensure that "independent contractors" are <u>truly</u> independent for both tax and non-tax purposes.

It has been an honor and privilege to be here this morning. Both NASFA and CEAA stand ready to work with you, Ms. Johnson, Mr. Matsui, Mr. Christensen, the members of this Committee, and your staffs to ensure fair treatment of exclusive agents. I will be pleased to answer any questions you may wish to ask.

Chairman JOHNSON. Thank you very much for your comments, and my thanks to the panel.

Mr. Hancock.

Mr. HANCOCK. Thank you.

I would just like to make one comment on especially the newspaper industry. I remember when the Saturday Evening Post was delivered by grade-school kids. I do not guess now under the independent contractor and all of the other rules and regulations they could even do that even if they wanted to, but I do not guess there is anybody on the panel who is old enough to remember that.

One question I have, Mr. Pyles, you mentioned your organization

is Coalition for Fair Worker Classification.

Mr. Pyles. That is correct.

Mr. HANCOCK. Could you furnish the Subcommittee with some of

the members of your organization?

Mr. PYLES. I would be glad to furnish you a list of all of the members, but I can just tell you it is about evenly split between the employer groups and employee groups. I can tell you about my association, that is, as a member. It is an association of small companies, very small companies—some just have a single office—and some of the largest staffing and home health companies in the country. Other associations that are members have employers of various sizes and some employee groups as well, but it is the only coalition that I know of that cuts across large and small employers and employers and employees.

Mr. HANCOCK. I would appreciate that information, if you would

provide that to the Committee.

Mr. PYLES. I would be glad to get it to you. [The following was subsequently received:]

1996 Member List

Auto Driveaway Company Chicago, Illinois

Building Service Contractors
Association International

Fairfax, Virginia

Carpentry Industry Partnership Norwalk, Connecticut

Fred Codding, Esq. Fairfax, Virginia

Harry L. Thomas, Inc. Stamford, Connecticut

Home Health Services and Staffing Association Alexandria, Virginia

Institute of the Ironworking Industry Washington, D.C.

International Brotherhood of Teamsters Washington, D.C.

International Union of Operating Engineers Washington, D.C.

Metropolitan Limousine Chicago, Illinois Naperville Chauffering, Ltd. Naperville, Illinois

National Alliance for Fair Contracting Washington, D.C. 20001

National Constructors Association Washington, D.C.

National Technical Services Association Alexandria, Virginia

Painters & Allied Trades Washington, D.C.

Service Employees International Union Washington, D.C.

Unions for the Performing Arts New York, New York

US Cargo and Courier Service Columbus, Ohio

United Brotherhood of Carpenters and Joiners Washington, D.C. Mr. HANCOCK. Thank you.

Chairman JOHNSON. Mr. Kleczka.

Mr. KLECZKA. Thank you, Madam Chairman.

We got off on a discussion on the last panel of types of independent contractors, and we used the example of the CPA, Ms. Horton who was with us, who charged \$150 an hour for her firm's work, not necessarily for her own, and then also, the computer person who comes into a small business or any business, and since we are moving into that age very rapidly of massive consulting, those are not the independent contractors that are causing a problem.

In fact, I was a small business person myself. There was no rea-

In fact, I was a small business person myself. There was no reason I should have a full-time CPA accountant on staff. So, he would do the books on a monthly basis and do the taxes, and that is not

what is causing the problem today.

Let me ask you, Mr. Pfotenhauer, how many drivers did you say you had with your firm? 82,000?

Mr. PFOTENHAUER. 82,000.

Mr. KLECZKA. Wow. Now, what would be the effect on your operation should the Christensen bill pass, which is not a possibility, but nevertheless, as an example, what would happen?

Mr. PFOTENHAUER. I think you would find that it would be easier to start a company using independent contractors in our industry sector, and it might become possible to shift from an employee-based work force to a work force using independent contractors.

What you would have in that situation is a market that is extraordinarily competitive, and one in which the margins are thin. You would have a number of competitors who would make use of independent contractor.

Mr. KLECZKA. High-labor intensity.

Mr. PFOTENHAUER. High-labor intensity. You would have competitors who had a very real cost advantage, probably in the area of about a 50-percent cost advantage when it came to their labor.

As you will recall, labor is about 60 percent of our overall cost,

which puts it at around \$13 to \$14 billion a year.

Mr. KLECZKA. We were told by previous testimony that there is no cost savings between an independent contractor and an employee. What is your reaction to that? I will ask Mr. Pyles, also.

Mr. PFOTENHAUER. It seems to me that the answer has already been provided, if I have heard correctly, because we are talking always about different industry sectors, and if we were to recommend anything, it would be that we become very industry-specific in looking at these issues.

We need to have a process set up by which we can address the issues of independent contracting, its impact on a specific industry

sector, in a very open and constructive way.

I think that you would find that different industries would have different stories to tell.

Mr. KLECZKA, Mr. Pvles.

Mr. PYLES. I think the clearest indication of whether or not there is an advantage is just to look at who is supporting the bill, and look at who is providing what testimony.

It is employers who want to reclassify workers, and I can just tell you from the standpoint of the Coalition that our employer association that it is a part of, various estimates have been given to me that the cost of doing business through employees versus independent contractors is a differential of about 30 percent in overhead cost of collecting the taxes, of paying the taxes, doing the withholding, providing the benefits, and complying with all of the requirements that go with a worker, a worker being classified as an employee. Our companies feel like they understand the law. The IRS has been absolutely consistent in making interpretations in our area, and I have yet to hear anyone who has had a problem with the IRS on this tell us whether or not they bothered to ask how their workers should be classified.

The IRS in our experience has been extremely forthcoming with information, and you can get an instant determining from them as to whether any particular class of worker under current law should be classified as an employee or independent contractor. Certainly, the law is ambiguous and needs to be clarified, but there are ways to avoid being blind-sided, and even a small business ought to avail themselves of it.

Mr. KLECZKA. One of the questions I asked the Treasury representative, the Assistant Secretary for Tax Policy, was whether or

not they look at sector practices in groups.

Let us take UPS for an example. You have competitors in the field. Let us say there are five, off the top of my head, and all of your competitors have employees, and you issue each employee a truck, a uniform, benefits, and all of a sudden, package deliverer No. 6 comes on board, does uniforms, trucks, but also calls them independent contractors. I would think, and you can respond, that should be taken into the mix and somehow looked at when this judgment is being made.

Mr. PFOTENHAUER. Very much so. I think that you would have to go back in and look at what has happened in the industry over the past 20 years and look at new entrants in the industry, and keep in mind that your goal is to neither advantage nor disadvantage a competitor with a law that is put forward out of this body.

That retrospective view would be very helpful.

Mr. KLECZKA. Mr. Doctor, I am still trying to get clear on your testimony. I assume that independent insurance agents are today classified as independent contractors.

Mr. DOCTOR. The exclusive agents are termed, exclusive agents being primarily captive to one company, as independent contractors. Yes, that is correct.

Mr. KLECZKA. Is there a problem with IRS in trying to reclassify those workers?

Mr. DOCTOR. No.

Mr. KLECZKA. You are supporting the Christensen bill, I assume, from what you have said, and I am thinking that for your employee group, you do not need any help from Christensen. You are doing fine on your own.

Mr. DOCTOR. That is right. We do not need any help from him, and in fact, if his bill went through as is, it would strip away the

protection that we have had for all of these years.

The 20-factor test has been a protective layer for us, and under the new simpler test, that would allow the companies to be in a position to take control of our time, place, and manner of doing business, our whole business operation. Mr. KLECZKA. So, you currently have a problem with your treatment as independent contractors. However, if the Christensen bill did pass in its current form, that would pose a problem.

Mr. DOCTOR. Yes, it would.

Mr. KLECZKA. So, are you still for the Christensen bill?

Mr. DOCTOR. If we could have it amended, as I said in my talk here, if we could amend it to include tax and nontax purposes, we would take a much harder look at it, yes.

Mr. KLECZKA. One of your comments was you do not want to be

treated as employees for tax purposes. Is that accurate?

Mr. DOCTOR. We are—no, we do not want to be treated as em-

ployees in any manner.

Mr. KLECZKA. OK, but you did mention tax purposes specifically. Is there additional liability if you are treated as an employee versus an independent contractor? The FICA tax would be the same.

Mr. DOCTOR. Additional liability to us if we were an employee?

Mr. KLECZKA. For tax purposes, what is the difference between

being treated as an employee?

Mr. DOCTOR. We would actually pay less. We would pay more in taxes as an independent contractor than we would as an employee. The respective companies, I doubt would want to pick up the 50 to 60 percent overhead that we pay. They appear to be going in the direction. The Christensen bill would allow them to keep the in connection facade or title while opening up the control factor to them to treat us as employees legally under the new law that would pass.

Mr. KLECZKA. Your problem is the control aspect.

Mr. Doctor. Yes.

Mr. KLECZKA. OK. Thank you very much.

Chairman JOHNSON. Thank you.

Mr. Pyles, it appears that you are mostly concerned with intentional reclassification of workers and inappropriate classification of workers, but wouldn't you agree that where there is a long history of independent contractor status and where it seems rational that those companies, those independent contractors ought to have some protection under the law?

Mr. PYLES. Before I answer, let me just say I would like to second Mr. Hoyer's comments about your thoughtfulness, and certainly in the home health area, it has been very much appreciated.

I am glad you are working on this issue.

As far as longstanding practice in an industry, there is a safe harbor there right now that does provide a safety valve for long-standing industry practice. The problem, though, is that section 530, as been used as a weapon by those who seek to gain a competitive advantage in the marketplace.

What we are seeing is that it is being abused not in the areas where there has been some longstanding practice. I am not aware of any case where the IRS has refused to acknowledge some long-

standing practice. There might be one, but I haven't seen it.

Chairman JOHNSON. Actually, there are a lot. I mean, this is one

of the things we are concerned about.

Mr. PYLES. OK. If that is true, then the IRS is disobeying the law, it's just that simple, and the courts, apparently. If that law has not been upheld in courts, then the courts have not been rec-

ognizing the law, but there are remedies. There are rights there, and there are remedies currently on the books for that, but where the abuse occurs is where a company gets a prior audit, for example, and then intentionally, can intentionally stand on a soap box in Times Square and say I am purposefully and intentionally misclassifying my workers and you cannot lay a glove on me.

Chairman JOHNSON. Yes, I appreciate that, and we did have

some very good testimony about how we need to fine tune that.

Mr. Pyles. Well, that and also-

Chairman JOHNSON. But you do not object to the underlying concept of section 530 that does provide some certainty to industries that have long used an independent contractor structure?

Mr. Pyles. I am sorry. What was your question?

Chairman JOHNSON. That you do not object to—in other words, one of the problems in this area of the law is that you have government coming back into it. I mean, the newspaper carriers are a perfect example. You traditionally have done business this way.

We had a lot of testimony from people who lay cable. The cablelaying business has always been an independent contractor

business.

So, one of the goals of section 530 was to protect people from the government arbitrarily going in for their own purposes, and partly because when they go in, they go in with much more power than any individual has to respond to that, and we just have had endless stories about that.

Mr. Pyles. That happens in almost any area of the law. It happens certainly in the health area, but I can tell you I think you have to back up one step. I think you have to back up and look at what is the fundamental premise of the distinction between employees and independent contractors in not only the tax law, but every law that has made such a distinction. The one element throughout the entire 200-year history of this country has been right to control.

If there is an industry that has been in existence a long time and absolutely the employers control every single nuance of what that employee does, then you would think the industry doing business in the area and having to apply this principle, and they must have had to apply it in many circumstances, would have some knowledge

of a 200-year-old principle.

Now, I suppose I have some sympathy if they haven't been investigated and penalized by the IRS in 200 years as with the newspaper industry down here, but I have to say that the law does require this distinction to be made on the basis of control, and at

least that element in the law has been pretty consistent.

So, you might want to go back now and change the law, but if you do go back and change this law to take control as an element out as of the distinction between employee and independent contractor, then you are putting the tax laws completely out of step with every other law that has ever tried to distinguish between employees and independent contractors.

Chairman JOHNSON. I appreciate your concern about the issue of control I do not think it is as simple as taking it out because, for example, the whole purpose of section 530 is to say people have always done it this way. Carriers have always worked for a newspaper. If a newspaper wants their newspapers delivered three times a day instead of once a day, they do it, wouldn't you agree? So, they do have control. Nonetheless, the history of this industry is-

Mr. PYLES. Well, I think the issue is how do you craft a rule that you can apply across all industries because it is not always easy to distinguish between industries.

Chairman JOHNSON. Well, of course, that has been a fundamen-

tal problem.

Mr. Pyles. I personally represent mostly business, mostly employers, and what employers want more than anything is consistency. They want to know what the rules are. I mean, they would like to have less rules, but they want to know what the rules are. Chairman JOHNSON. That is absolutely true. Absolutely.

Mr. Pyles. I think we would agree, everyone agrees we need clearer rules here, but I think if you have a rule here where you distinguish between employers and independent contractors based on control, then you need to apply it consistently. It needs to apply to the newspaper industry. It needs to apply to the trucking industry. It needs to apply to the health industry.

[The following was subsequently received:]

HOME HEALTH SERVICES A STAFFING ASSOCIATION



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July 9, 1996

Congresswoman Nancy L. Johnson Chairman, Subcommittee on Oversight House Ways and Means Committee 1102 Longworth Building Washington, D.C. 20515-6348

Re: Hearing on Worker Classification Issues

Dear Chairman Johnson:

At the June 20 hearing on Worker Classification, you asked me a question for which time did not permit a complete answer. You correctly noted that the association I represent is principally concerned with the intentional abuse of the employment classification laws, and particularly § 530, by those who seek an competitive advantage over law-abiding companies. Tr. at 191.

You asked me, however, whether I thought some protection should be made available to companies that have a long history of treating workers as independent contractors. Tr. at 191-193. My response was that § 530 currently offers protection for longstanding industry practice but that the public policy analysis must start one step earlier. Tr. at 193.

The first question must be "What is the fundamental concept for distinguishing between employees and independent contractors?" If it is "right to control the means and method of performing the work" as it has been throughout the 200-year history of this country, then that criterion should be applied consistently.

If exceptions are to be granted, they should be granted sparingly, and the burden of obtaining an exception should be on the one seeking it. Otherwise, the exceptions will be used as a weapon by those who seek to gain a competitive advantage, and the law will slide into arbitrary enforcement, as has been the effect of § 530

It would not seem to be sound public policy to provide that a company could successfully defend its misclassification of workers on the grounds that it had done so for many years. This approach would send the message that if you violate the law often enough, long enough, you can get away with it.

Thus, the question for Congressman Gilchrest's bus company and for Congressman Hoyer's newspaper is, did they control the means and method by which the jobs were performed? If so, the next question should be, what basis did they have for concluding that the workers were properly classified as independent contractors, given the extent of the control? If it is determined that they found the law unclear, what efforts did they make to obtain clarification?

In the absence of this type of analysis, Congress ignores the interests of the bus company that might have lost the county contract because it treated its drivers as employees. It also ignores the interests of the drivers who may have lost their health insurance, retirement, and other fringe benefits when they were reclassified without their consent.

The current state of the law is untenable because it is ambiguous and § 530 prevents the IRS from clarifying it. Based on past history, it is unlikely that Congress will be able to draft criteria that equitably and reliably distinguish between employees and independent contractors. Accordingly, we recommend that Congress repeal the § 530 ban on clarifying regulations, circumscribe the IRS' authority to issue such regulations, require the IRS to clarify the law through a rule making in which the entire public can participate and the IRS can bring its technical expertise to bear, and phase out the § 530 safe harbors once the law has been clarified.

We appreciated the opportunity to testify and look forward to working with you to resolve this difficult issue.

Sincerely,

James C. Pyles

Chairman JOHNSON. Of course, the problem is that if control hasn't been the key issue over decades, is it in society's interest to make it the key issue now? One of the points of section 530 is to recognize that the same criteria does not necessarily exist across the board.

It is just like many of you have made the argument that independent contractors put you at a competitive disadvantage, and yet, today we have had good testimony that independent contractors get paid more than some employees, and both are true.

Mr. PYLES. Two different issues, yes. Two different comments.

Chairman JOHNSON. Both are true.

Mr. PYLES. Right, both are true.

Chairman JOHNSON. So, you cannot write a law based on the assumption that independent contractors are solely a way to lower labor cost because that isn't true. Independent contractors are often a way to get expertise, and they have nothing to do with lowering labor cost.

So, we do have to be careful that we do not proceed to reform this area of the law with any single, simplistic concern as our guide, and we will table our proposal in such a way that we hope everybody who has taken the time and effort to be here and to give

us their thoughts will have a chance to comment.

Now, clearly, it is not going to satisfy everybody. It is not going to be a bright line. This is a difficult area. Common sense tells you that common law in this area is not easy, but we do hope to be able to offer some clarifications and some clearer structure that will give the majority of those who are affected by this sector of the Code greater confidence and a greater protection and a greater security, and I personally hope that we can prevent problems like that from developing in the school district of Maryland because that kind of action on the part of the government is destabilizing to both the economy and to the society in a way that seems to have very little net economic benefit and very little net public value in the sense that we are not going to collect a lot more money and it is not going to be a lot fairer.

So, we want to look at all of those groups that aren't reporting at all, how do we make this a better, fairer, and more consistent system, and we thank you for your input today. Thank you.

Chairman JOHNSON. The meeting stands adjourned. [Whereupon, at 3:43 p.m., the hearing was adjourned.] [Submissions for the record follow:]

SUBMITTED STATEMENT OF THE AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS TO THE SUBCOMMITTEE ON OVERSIGHT OF THE HOUSE COMMITTEE ON WAYS AND MEANS ON H.R. 1972 AND H.R. 582

July 22, 1996

The American Federation of Labor and Congress of Industrial Organizations (AFL-CIO) appreciates this opportunity to present its views on H.R. 1972 and H.R. 582; Section 530 of the Revenue Act of 1978; and the principles that should guide any legislative effort to clarify the distinction between "employees" and "independent contractors" for federal tax purposes. The AFL-CIO approaches this issue from a longstanding conviction that the tax laws' current treatment of employee classification is untenably imprecise and subject to employer manipulation and other abuses; and that the influence of tax code principles on federal employment law statutes warrants considerable care in any legislative response.

The Problems Under Current Law

Section 530(b) of the Revenue Act of 1978, PL 95-600, currently precludes the issuance of regulations or revenue rulings regarding the "employment status of any individual for purposes of the employment taxes" governed by the Internal Revenue Code until Congress enacts a statute clarifying that status. Section 530 was originally enacted as a one-year, temporary measure while Congress devised a permanent solution to the employee-independent contractor issue. Instead, Congress has failed to achieve one and Section 530 has been extended indefinitely, and so for 18 years now has tied the hands of the Department of Treasury, including the Internal Revenue Service, in providing guidance to taxpayers other than in private letter rulings that lack precedential force.

This unwise legislative restraint has persisted despite the significant changes that have marked the American workplace during this period. There has been a fundamental evolution in the relationships between enterprises for which services are performed -- that is, "employers" in a broad and non-statutory-specific sense -- on the one hand, and those who provide these services -- "employees," again in a broad and non-statutory-specific sense -- on the other hand. Part-time, temporary, contractual and other "contingent" jobs have exploded in number. Many of these positions did not exist in 1978; but an overwhelming number are simply new arrangements for the same work that both the law and common sense ordinarily considered to be performed in the relation of employer and employee.

For purposes of both the Internal Revenue Code and other statutes that regulate workplace relations, important legal consequences depend upon whether jobholders are defined as employees or independent contractors. Increasingly, workers are classified -- usually at the behest of enterprises for which services are performed -- as independent contractors. There are now construction industry companies that treat every one of the craftpersons who perform work for them as an independent contractor; taxi companies that "discharge" all their drivers and then require that they lease their cabs for a week at a time if they wish to continue to work, now as independent contractors; offices that "lay off" executives and other personnel and then contract for their services as "consultants," again with the independent contractor label; and even agricultural employers that call the migrant farmworkers who pick their produce independent contractors, despite the fact that these workers are as completely dependent upon these employers for their livelihoods as they were when they were "employees."

The minimal changes such reclassifications bring in the actual, day-to-day relationships between enterprises and job performers stands sharply contrasts with the radically different treatment accorded them by the tax code and federal employee protection laws. In most respects these laws make it cheaper and administratively simpler for enterprises to classify employees as independent contractors. These are powerful incentives that more and more employers choose not to resist. Unfortunately, the expense resulting from this definitional sleight of hand is borne

by the U.S. Treasury in the form of lost revenue, and by the workers and their families in the form of higher costs, economic insecurity and foregone benefits and legal protections.

Under the tax laws, which the proposed bills would affect most directly, the independent contractor-employee distinction governs whether enterprises must withhold income tax, withhold and pay Social Security and Medicare contributions, and pay federal and state unemployment taxes: businesses must do so for employees, but not for independent contractors. Independent contractors, but not employees, are fully responsible for the calculation and payment of federal income tax, Social Security and Medicare contributions, and they may deduct from their income certain business expenses not available to employees — all burdens not easily carried, particularly by misclassified workers who are not skilled or professional persons.

The adverse impact of erroneous and intentional misclassification of employees as independent contractors on revenue collection and tax code administration is severe. In 1990 the House Government Operations Committee issued a report estimating that the misclassification of workers under the federal tax laws results in annual revenue losses in the billions of dollars.\(^1\) Meanwhile, from 1979 to 1994 the number of annual IRS audits of employment tax returns declined by 38%. Yet a 1984 IRS audit focusing on employee misclassification determined that nearly 15% of employers misclassified employees as independent contractors.\(^2\) The IRS survey found that when employers classified workers as employees, the employers reported more than 99% of their wage and salary income, but when they classified workers as independent contractors, only 77% of gross income was reported, and only 29% was reported when the appropriate IRS form (Form 1099) was filed.

The adverse consequences under national employee protection laws of misclassification as independent contractors are equally, if not more, troubling. Virtually all federal statutes that protect workers -- including the National Labor Relations Act, the Fair Labor Standards Act, the Occupational Safety and Health Act, the Civil Rights Act, the Americans with Disabilities Act and many more -- protect employees, not independent contractors. State laws that provide additional workplace protections, such as workers' compensation statutes, also usually apply only to the employer-employee relationship. And the same is true under other basic worker protection statutory arrangements under which federal and state law complement each other, such as unemployment insurance laws. In short, the employee-independent contractor distinction can make all the difference to those performing the work.

Additionally, employee benefits such as health insurance and pension plans are customarily provided by employers, if at all, only to employees, and when employers reclassify their employees as independent contractors these coverages ordinarily terminate. These workers must then -- usually with no increase in actual take home-pay -- finance such coverage themselves; but this is often an impossible task by reason of expense, complexity or both. The resulting social costs are heavy on these workers, their families and society. And a related problem arises under the Employee Retirement Income Security Act requirement concerning coverage of all employees where a pension plan is adopted; that rule is subject to evasion by misclassification.

Principles to Guide a Legislative Solution

Because the federal tax code so potently influences how employers structure their business operations and their relations with those who provide services to them, the AFL-CIO

¹ House Committee on Government Operations. Lax Administration Problems Involving Independent Contractors," H.R. Rep. 101-979, 101st Cong., 2d Sess. (1990). This report in turn was based on three studies by the General Accounting Office.

² Internal Revenue Service, Strategic Initiative on Withholding Non-Compliance (SVC-1) Employer Survey Report of Findings (June 1989).

believes that only legislative action can fix the misclassification mess.

Since the Supreme Court's decision in <u>Nationwide Mutual Insurance Company v.</u>
<u>Darden</u>, 503 U.S. 318 (1992), the common law distinction between employee and independent contractor has been understood to apply under every federal statute that uses the term "employ" (or a variation of it) without defining this term. But pressing this common law distinction into such broad statutory service has failed for several reasons.

First, the common law distinction was developed primarily to determine the circumstances in which a business would be held vicariously liable for injuries caused by individuals performing work on its behalf. Consistent with that purpose, the common law test turns principally upon factors relevant to an enterprise's ability to direct or control the individual performing services for it. But as Judge Frank Easterbrook of the United States Court of Appeals for the Seventh Circuit has noted, while this emphasis upon direction and control makes sense in the vicarious liability context, it should not necessarily govern elsewhere. Secretary of Labor v. Lauritzen, 835 F.2d 1539, 1544 (7th Cir. 1987) (Easterbrook, J., concurring).

As Judge Easterbrook observed, where the question is "who is answerable for a wrong (and therefore, indirectly, to determine who must take care to prevent injuries)," the emphasis on direction and control is appropriate because that approach focuses upon "[who] is in the best position to determine what care is appropriate, to take that care, or to spread the risk of loss." But "[t]he reasons for blocking vicarious liability at a particular point [may] have nothing to do with the functions of" the various federal statutory schemes into which the common law concept has been incorporated. Id.

For example, the federal withholding and Social Security and Medicare tax schemes are primarily concerned with collecting revenue due to the government. While so-called "independent contractors" are themselves liable for paying their income and FICA (but not federal or state unemployment) taxes, the practical consequence of creating incentives for businesses to treat workers as "independent contractors" and placing a compliance obligation on individuals who are not well-equipped to shoulder that burden is to drive more and more of these individuals into the underground economy, and to make it more and more difficult for the government to ascertain compliance with the tax laws. It is surely relevant, in devising and administering a federal tax collection enforcement scheme, that businesses ordinarily can easier undertake to withhold income taxes and pay part of the FICA tax than can individual workers who are classified as independent contractors. Fairly defining work relationships in a manner that enhances reporting and collection of taxes lessens the likelihood of taxpayer compliance problems and removes opportunities for out-and-out evasion of tax obligations. The common law, tort-oriented approach to this issue, of course, takes none of these considerations into account.

Second, in spelling out the common law distinction, the courts and agencies have tended toward standards that are both complex and subjective. For example, the IRS guideline (Revenue Ruling 87-41) enumerates 20 relevant "factors" ranging from how the individual is trained to how the individual is paid to whether the individual works on or off the employer's premises. In any given situation these factors will almost always pull in more than one direction, although most of them are certainly relevant to ascertaining the actual nature of an employment relationship. But the IRS test assigns no weight to any factor, and the absence of a unifying theme or principle results in their highly subjective and uncertain application.

Indeed, the IRS standard easily lends itself to manipulation by businesses seeking to minimize their tax burden. The business can set up the relationship with its workers so as to meet a substantial number of the criteria for independent contractor status -- by altering, for example, the mode of pay, work hours, or degree of direct supervision of job performance -- and do so without varying the underlying realities of entrepreneurial control, capital investment and economic dependence.

In light of these grave problems with the current criteria for determining employee status

and of the broad-ranging impact of the misclassification problem, the AFL-CIO believes that Congress should abandon the common law test for distinguishing "employee" from "independent contractor" status for determining tax obligations and, indeed, for all purposes unrelated to the tort liability analysis function for which that test was created. At the very least Congress must adopt a simpler and more consistent approach than the 20-factor test that Congress has effectively mandated due to Section 530. And any such approach must continue to be national in scope.

In recent years, several federal and state courts, applying employee protective statutes, have articulated a standard that focuses not on direction and control considerations, but on considerations related to the working person's economic dependence on the enterprise that purchases his or her services. The ultimate question to be answered under such standards is whether the job performer is a discrete, economically independent enterprise, or a provider of services operating within another's enterprise. A standard directed toward this end would stress factors such as opportunity for profit and loss; investment in equipment or materials; partnership or other economic association with others; degree of continuity of the relationship; liability for task completion; and whether the service rendered is an integral part of the employer's business.

These factors are considered in federal and state cases applying the Fair Labor Standards Act and workers' compensation laws, and also appear in the "statutory employee" standards of 26 U.S.C. § 3121(d)(3), which provides that individuals performing certain services are employees as long as they personally perform the services, have no substantial investment in facilities other than transportation, and have a continuing relationship with the business, irrespective of other common law factors.

Such factors go to the core of the relationship between the business and the service provider. They address matters that are directly connected to the question whether or not an individual is a discrete economic enterprise, and they raise fewer and less subjective considerations than the 20-factor test that has proven so inadequate.

To this extent the AFL-CIO agrees with the conclusion of the 1995 White House Conference on Small Business that "realistic and consistent guidelines" must govern the employee-independent contractor issue. We are pleased that the Treasury Department, as reflected in the statement to this committee on June 20, 1996, by Acting Assistant Secretary for Tax Policy Donald C. Lubick, also supports scrapping the 20-factor test, although the AFL-CIO and the Treasury Department may diverge regarding the standard that most appropriately would replace it.

In the AFL-CIO's view, any statutory definition should contain a presumption in favor of a determination that a work relationship is that of employer and employee unless the worker's status satisfies a relatively rigorous definition of independent contractor status. Although we are not prepared now to propose an alternative formula, the FLSA and workers' compensation experience suggest the proper direction. We commend in particular to the Committee's review the enactments of the legislatures of Minnesota and Wisconsin, which have defined independent contractors for purposes of their respective workers' compensation laws, requiring that, for purposes of satisfying an independent contractor definition, individuals satisfy each of nine specified elements. See Wis. Stat. § 102.07(b); 1996 Minn. Statutes 1995 Supplement § 176.042.³

³ These statutes define an independent contractor as one who:

⁽¹⁾ Maintains a separate business with the independent contractor's own office, equipment, materials and other facilities;

⁽²⁾ Holds or has applied for a federal employer identification number;

Because the reclassification of workers from employees to independent contractors often results in less cost to the employer, the existence of vague and manipulable standards provides a potent temptation to employers to gain a competitive advantage by going the independent contractor route, while punishing employers who act in good faith and behave in accordance with ordinary and responsible norms by classifying those they employ as the employees they are.

Section 530 of the Revenue Act of 1978

The AFL-CIO also recommends that the so-called "safe harbor" provisions of Section 530 be abandoned. Section 530 fosters tax treatment and tax benefits on the basis of happenstance by permitting employers to treat a worker as an independent contractor for employment tax purposes (albeit not for income tax purposes) regardless of the person's actual status under the common law test if the employer has consistently treated the individual as an independent contractor for tax purposes, unless the employer "had no reasonable basis for not treating such individual as an employee." Section 530(a)(1). In order to satisfy this standard, Section 530 permits the employer to continue treating an individual as an independent contractor so long as it relied on judicial precedent, published rulings or IRS advice; underwent an IRS audit that resulted in no employment tax assessment for similarly situated individuals; there is a longstanding recognized practice of such classification in the employer's industry; or there exists some other reasonable basis.

In the AFL-CIO's view, it is long past time to treat all businesses in the same manner and end the patchwork of tax compliance that Section 530 preserves. Because Section 530's safe harbor rules were never intended to be permanent provisions, their distortions of the tax code and employer practices have simply become more extreme and unjustifiable over time. Nothing short of repeal will restore uniformity and equity to this critical aspect of our tax laws. We cannot continue to treat persons as non-employees who, all concede, are employees merely because they satisfy what was intended as a stop-gap exception to the tax code, but which has now persisted for 18 years without any principled basis.

We recognize that in H.R. 3448, the Small Business Job Protection Act of 1996, the Senate recently passed an amendment to Section 530 that would partially tighten it by limiting the safe harbor audits to those that actually examine the classification of employees for

⁽³⁾ Operates under contracts to perform specific services or work for specific amounts of money and under which the independent contractor controls the means of performing the services or work;

⁽⁴⁾ Incurs the main expenses related to the service or work that the independent contract performs under contract;

⁽⁵⁾ Is responsible for the satisfactory completion of work or services that the independent contracts to perform and is liable for a failure to complete the work or service;

⁽⁶⁾ Receives compensation for work or service performed under a contract on a commission or per-job or competitive bid basis and not on any other basis;

⁽⁷⁾ May realize a profit or suffer a loss under contracts to perform work or service:

⁽⁸⁾ Has continuing or recurring business liabilities or obligations; and

⁽⁹⁾ The success or failure of the independent contractor's business depends on the relationship of business receipts to expenditures.

employment tax purposes. But in addition to that somewhat salutary change, H.R. 3448 takes several steps backward.

First, it provides that the industry practice safe harbor may be satisfied by a showing that not more than 25% of the industry is so engaged. But application of this threshold, even if it were determinable as a practical matter in a particular instance, could be highly inappropriate. And it could reflect widespread industry misclassification, thereby making lawlessness the justification for its own perpetuation.

Second, H.R. 3448 provides that the longstanding industry practice may not be required to have lasted for more than ten years' duration. This limitation too can only tilt in favor of a finding of independent contractor status and is again insensitive to variations among different sectors of the economy.

Third, H.R. 3448 provides that in applying any of the safe harbor factors, the burden of proof shifts from the business to the IRS once the business establishes a <u>prima facie</u> case that it was reasonable not to treat an individual as an employee for tax purposes and the business has cooperated with reasonable requests from the Treasury Department. We perceive no justification for putting the onus on the Treasury Department rather than on the employer for the latter to secure its preferred classification.

Fourth, H.R. 3488 provides that the Section 530 safe harbors are available regardless of whether the individual involved is otherwise an employee. This provision's only apparent purpose is to enable an employer to enjoy Section 530 benefits without risking coverage by non-tax laws that protect "employees." The tax code should not afford employers a safe harbor that serves no tax-related purpose.

Finally, in another apparent attempt at tightening these requirements, H.R. 3448 requires a written agreement between the enterprise and the individual stating that the individual will not be treated as an employee for tax purposes. But such a requirement could be easily met where classification abuse occurs, since the inequality of bargaining power between employer and worker renders this a matter largely of form rather than substance. Also, this requirement hardly provides useful notice to employees; most workers already understand the basic difference between paychecks that are subject to federal and state mandated withholdings and those that are paid in lump sum without them.

We now turn to the two bills under consideration.

Independent Contractor Tax Simplification Act of 1995, H.R. 1972

The AFL-CIO agrees with the stated purposes of H.R. 1972, namely, to simplify the tax rules and create "fair and objective rules for determining who is an employee and who is an independent contractor." Unfortunately, H.R. 1972's attempt to update and rationalize these definitions for employment tax purposes falls short of what is necessary to address the problems we have identified.

H.R. 1972 creates a menu of indicia for independent contractor status, directing that a socalled "service provider" shall not be treated as an "employee" (and so, although the bill does not use the phrase, will be considered an "independent contractor") so long as there is a written contract so stating, and so long as the service provider satisfies at least one factor on each of two lists of alternatives.

As we have just described in connection with H.R. 3448, the requirement of a written contract has little practical value. As for the menu, the options that need to be satisfied in order to secure independent contractor status are so limited that H.R. 1972 will make it easier than it is under current law for an employer to structure its employment relationships so as to produce independent contractors in its work force. For example, the first group of factors, in bill section

3511(b)(1), requires that the worker have "a significant investment in assets and/or training." The term "significant" is undefined and easily susceptible to imaginative readings. So then, a worker who has gone through an apprenticeship program, taken some relevant community college courses, or majored in a particular subject in college might qualify under the training factor, and a worker who owns a vehicle or tools that are used in the course of his or her work might satisfy the "assets" criterion.

Among the second group of factors, in section 3511(c)(1)(B), is one requiring that the worker "does not primarily provide the service in the service recipient's place of business." The phrase "place of business" is undefined, so any company that performs its services on the premises of customers could easily qualify under this description. Other matchings from the two menus in H.R. 3448 likewise produce combinations that are insufficiently demanding for a determination of independent contractor status, despite the important tax and other consequences of that classification.

We recognize that H.R. 1972 attempts to address a major deficiency in our tax laws by seeking to replace the current framework with a simpler and more comprehensible approach. But we submit that it fails to provide a definition that will achieve the necessary goals of simplicity, clarity, fairness and non-susceptibility to manipulation and evasion. Accordingly, the AFL-CIO oppose this bill.

The Independent Contractor Tax Fairness Act of 1995, H.R. 582

Like H.R. 1972, H.R. 582 requires a written agreement, but one that specifies more detail about the nature of the services to be provided, the accounting for those services and the tax consequences of the arrangement. While this version is better, again it may be easily satisfied by an unscrupulous employer.

H.R. 582 also would grant non-employee (independent contractor) status if, in addition to such an agreement, <u>any</u> of four factors were present, namely: (a) potential for realization of profit or loss; (b) maintenance of separate principal place of business; (c) making services available to the general public; or (d) receiving payment on a commission basis. The statute then elaborates how each of these alternatives may be satisfied.

Again, the AFL-CIO does not believe that these minimal standards will present much of a problem to an employer intent on achieving the manipulation that the law must be crafted to prevent. We are also concerned that H.R. 582 postpones to a later day a final legislative resolution of this issue by requiring the Secretary of the Treasury to propose within 180 days of enactment legislation that specifies objectively measurable criteria for determining whether a worker is an employee or an independent contractor for federal tax purposes. Of special concern is the bill's directive that such proposed legislation allow employers maximum latitude in determining worker classification. Again, that is precisely the opposite of what should be the case.

H.R. 582 is also deficient in that it would largely preserve Section 530. And this bill includes some revisions like those in H.R. 3448 -- for example, the 25% limit on the requisite industry practice -- that would worsen Section 530, although it would strengthen the audit safe harbor in a more stringent manner than would H.R. 1972. But, again, Section 530 should be repealed, not tinkered with. Accordingly, the ALL CLO opposes H.R. 582 as well.

Conclusion

The AFL-CIO favors a legislative effort to recent the deeply flawed treatment of the employee - independent contractor distinction under the Internal Revenue Code. Because so much is at stake in any legislative solution, we urge that Congress approach this matter with considerable deliberation and a clear understanding of the practical consequences that will ensue. These consequences may include a direct impact by a revised tax code on judicial treatment of the employee-independent contractor distinction under current employee protection laws. For these reasons we urge that any legislation that treats these issues be presented in a free-standing bill, and not simply attached to greater and unrelated legislation, such as a reconciliation bill, that the Congress might feel constrained to pass regardless of what other legislation adorns it.

STATEMENT OF JOSEPH M. HARRISON ON BEHALF OF THE AMERICAN MOVERS CONFERENCE

My name is Joseph M. Harrison. I am President of the American Movers Conference (AMC.) This statement is submitted on behalf of nearly 3,000 household goods movers who are members of AMC. AMC is affiliated with the American Trucking Associations (ATA) and supports ATA in their statement to the Committee. AMC is the principal national trade association for the household goods moving industry, representing movers before Federal and State legislative and regulatory bodies. AMC members include small local moving companies often affiliated with a van line, independent van lines with regional or national markets, and national van lines with an agency network. In turn, these companies contract with van operators to drive, load and deliver household goods. Many of these van operators are treated as and have been deemed to be independent contractors.

AMC urges the Committee to consider five issues before proceeding with independent contractor legislation:

- Section 530 has worked well for many taxpayers, particularly small businesses and should therefore not be eroded in the guise of a "small business fix",
- the 20-factor common law test is often arbitrary, but the Market Segment Understanding (MSU) method can be cumbersome and time consuming and therefore will not prove to be a panacea for either the IRS or business,
- the compliance with government regulations should not cause workers to be reclassified,
- the IRS has recently developed some new directions and should be encouraged to continue their efforts but should not be allowed to proceed with regulations and
- · withholding for independent contractors should not be imposed as a solution.

Section 530 Should Not be Eroded

Section 530 "audit protection" is crucial to the moving industry as well as to many other industries. It is also part of the problem. Section 530 is not itself completely objective and disagreements about its application and availability have caused a good portion of the current controversies. AMC believes some of the modifications to Section 530 proposed by the Senate Finance Committee will prove helpful to small business.

AMC does not support the changes proposed by the Finance Committee to the prior audit safe harbor. An audit is a time-consuming and expensive proposition for small businesses. Without an internal accounting and legal staff, small moving companies must rely on outside auditors and attorneys during an IRS audit. This safe harbor was designed to protect businesses from repeated audits. Although this change would only apply prospectively, it could create a situation whereby small businesses could be subjected to repeat audits. To erode the notion of audit protection is to potentially open up the small companies to added expense and less clarity. Many AMC members have come to rely on the prior audit safe harbor and AMC believes it should be retained intact.

AMC does support the clarifications to Section 530 regarding long-standing industry practice. The Senate Finance Committee would specifically allow a long-standing industry practice if it had been in place for 10 years. AMC believes that this change will assist both the taxpayer and the IRS in defining this safe harbor.

Finally, AMC is concerned about the effect the written agreement requirement may have on other industries. Moving companies rely heavily on written agreements which are also necessitated by other Federal regulations. However, without a fact-finding opportunity it is difficult to assess the effect this change will have on other small companies in other industries.

The Market Segment Understanding (MSU) Program and the 20-Factor Common Law Test

Because of their extensive use of independent contractors, movers have long been subject to IRS employment audits. Many of AMC's members have found the audit process and the use of the 20-factor common law test to be a long, costly and arbitrary process. Since so many moving companies are small businesses, this process has necessitated the use of outside attorneys and auditors. Only after incurring substantial expenses can AMC members come away from an audit with workers classified as independent contractors. While AMC strongly supports the appropriate classification of workers, the battle for independent contractor satus is unnecessarily laborious and resource consuming. Perhaps the biggest stumbling block with the 20-factor common law test is the inconsistency in its application. Movers are faced with proving the validity of either all, most or some of the factors depending only upon the individual auditor. Movers have never been sure what, if any, individual factor might force workers to be reclassified, even in the absence of other concerns.

In the Fall of 1992, the IRS approached AMC and requested that the industry participate in a Compliance 2000 project to develop guidelines for tax classification of van operators which was later referred to as the "Moving Industry MSU." While AMC initially had reservations about entering into such a joint venture, we were assured throughout our discussions with the IRS that the aim of this project was to build a consensus through mutual trust and understanding which would result in the development of realistic criteria to aid in determining whether a van operator would be classified as an independent contractor or an employee.

AMC recruited volunteer representatives from all segments and organizations of the industry to participate in a joint venture with the IRS to reach a consensus on independent contractor criteria. An enormous amount of time was spent by these volunteers and AMC working on guidelines with IRS. Almost four years and numerous meetings later, the joint AMC/IRS Compliance 2000 Committee reached a consensus and in July 1995 IRS field representatives forwarded a draft MSU to the IRS national office. The industry group did not receive a response until January 24, 1996.

At the January meeting, we were told for the first time that the rules under which our joint Committee had been operating were no longer viable and in essence, the moving industry MSU document would no longer be a joint and mutually agreed upon product. According to the IRS, the changes were required at this time because of statutory provisions of the Federal Advisory Committee Act (FACA) of 1972. In addition, we were further dismayed to learn that in the future, industry would be dealing with a new IRS negotiating team from the Chief Counsel's office which had not been a participant during the three-year developmental period and thus were not acquainted with the industry, and that a key portion of the draft would be completely overhauled.

Since that time, we have been endeavoring to work with the new IRS negotiators to build a better understanding of industry issues and attempt to influence the development of realistic, workable audit guidelines. However, our experience with the MSU process suggests that it is a flawed procedure that will not be a viable alternative to the 20-factor common law test for most industries. The time commitment is huge, the process takes too long, and the IRS FACA interpretation does not permit a negotiated solution. Rather an industry may spend years providing input only to find that IRS issues guidelines with which it does not agree. This leaves industry in an extraordinarily vulnerable position.

Compliance with Governmental Regulations

One of the major areas of discussion between the moving industry and the IRS is the effect compliance with governmental regulations has on the control element. This has not been extensively addressed during these deliberations but should be a consideration of the Committee. Governmental regulations play a particularly sensitive role industries, like movers, that remain heavily regulated. Moving companies, like all trucking companies, must ensure the safety of the equipment

and drivers under contract to them. In addition, moving companies remain subject to interstate and intrastate economic regulation. There are numerous state and federal mandates which must be complied with regardless of whether a worker is an independent contractor or an employee. The IRS continues to view companies efforts to insure compliance with governmental regulations as control of the workers and therefore an element of the 20-factor common law test which tilts the workers toward employee status. AMC encourages the Ways and Means Committee to review this issue with the IRS. This issue should be addressed within the training materials in a more equitable manner. It is absurd for businesses to find workers reclassified only on the grounds of instructions or training necessitated by compliance with equally important regulations from other governmental entities.

Legislative Solutions and the IRS Initiatives

AMC has followed with great interest the various legislative solutions that have been proposed over the last several years for resolving the difficulties experienced by taxpayers and the IRS with the independent contractor vs. employee classification issue. Both H.R. 1972 and H.R. 582 would revise the standards for determining employee status, replacing the 20-factor test presently relied upon. H.R. 582 would repeal existing Section 530 and replace it (in part) with revised requirements.

We recognize that the 20-factor common law test for resolving the worker classification issues is subjective and uncertain to work well or to be applied easily to the wide variety of work arrangements that exist today. However, AMC believes this system is preferable to legislation. While the MSU process has been particularly cumbersome for this industry, the theory behind the work has great merit. Each industry has different work arrangements and essential elements of the 20-factor common law test should differ as the industry differs. Yet at the same time, we acknowledge that the government has a legitimate interest in limiting independent contractor status to those situations that objectively operate in such a manner. Legislation that permits such status to be claimed indiscriminately would not serve well.

From our experience we conclude that whatever solutions are found should apply even-handedly industry-wide. We also believe that appropriate factors for determining worker classification will vary by industry and sometimes by segments within an industry. Thus, while we support efforts at legislative improvement, we have reservations about the ability of any legislative solution to apply equally well and fairly in all industries and appropriate segments thereof. AMC applauds the Commissioner for the work on the training manual as a means to address these issues.

If Congress undertakes a broader-based legislative revision than changes to Section 530, AMC encourages the retention of safe harbor protections. We believe this step will be needed in order to provide an adequate level of comfort to taxpayers that any new legislation will be fairly applied and not lead to overly aggressive assertions by the IRS that will threaten the economic viability of existing businesses. A return to the conditions that led to the enactment of Section 530 cannot be viewed as progress.

Withholding Should Not Be Seen As A Solution

AMC opposes the imposition of withholding on independent contractors as a solution to the worker classification issue. Withholding will not solve the issue of appropriate classification of workers but will serve to penalize workers, such as in the moving industry. Van operators incur substantial operating expenses and withholding will only subject their revenue to another reduction.

Van operators are responsible for truck payment, fuel purchases, insurance and various other expenses and record keeping responsibilities. It is inappropriate to add withholding to their administrative burden. Withholding should be reserved for employees and should not be an added burden for small business independent contractors.

Conclusion

AMC encourages the Committee and the IRS to continue to grapple with the difficult problems of worker classification. AMC supports some modifications to Section 530 that will benefit small businesses and the IRS. However, AMC can not support legislation which will permit independent contractor classification without substantial justification.

Furthermore, AMC supports many of the initiatives suggested by the Treasury Department including expansion of the jurisdiction of Tax Courts to hear worker classification cases. However, AMC's experience with the MSU process would not lead us to support allowing the IRS to continue with further guidance beyond the audit guidelines now under consideration. Finally, AMC would be pleased to continue to work with both the IRS and this Committee in an attempt to refine solutions to this complicated issue.

STATEMENT OF THE AMERICAN PAYROLL ASSOCIATION

Concerning the June 4 and June 20, 1996 Hearings on Worker Classification Issues

Before the
OVERSIGHT SUBCOMMITTEE OF
THE WAYS AND MEANS COMMITTEE
UNITED STATES HOUSE OF REPRESENTATIVES

INTRODUCTION

The American Payroll Association (APA) is a nonprofit professional association representing more than 13,000 companies and individuals on issues relating to wage and employment tax withholding, reporting, and depositing. We estimate that over 70 percent of the gross federal revenues of the United States are reported, collected, and deposited through company payroll withholding. APA's members are the nation's information reporters and tax collectors.¹ Because our members are interested in the information reporting consequences of worker classification, not the corporate or individual tax consequences, they are caught in the middle of the worker classification debate. Often the worker prefers to be classified one way, management supports a different classification, and APA's members are forced to decide how to report information and/or withhold and deposit taxes for that worker, based upon unclear rules, and faced with the constant prospect of IRS audits and penalty exposure. However, most of APA's members are not tax lawyers, nor do they have the time, expertise, or resources to research complicated tax questions. Thus, APA strongly encourages the Committee to support legislation that would simplify the legal standard for classifying workers.

STATEMENT

The purpose of our statement is to register APA's support for legislative efforts to clarify and simplify the federal tax rules governing the classification of workers as employees or independent contractors. The current standard, the common law "control test," is unwieldy and highly subjective, resulting in payroll professionals making very difficult decisions about how to report compensation and whether to withhold and pay employment taxes. The problem does not end there, however. An individual's classification also determines how certain fringe benefits, such as health and life insurance, should be reported (if at all) and whether certain individuals should be allowed to participate in a company's pension plan. Not only can the penalties for failing to report these items properly be staggering, but the financial burden that a company must bear to defend itself during a

¹ The Court of Federal Claims has characterized payroll professionals as the "deputy tax collector." General Elevator v. United States, 90-1 U.S.T.C. ¶ 50,248.

protracted audit, and even litigation, of worker classification issues can jeopardize a company's existence.

Payroll professionals are often charged with the task of deciding how to classify individuals for payroll withholding and reporting purposes. Hinging this important decision on such a subjective test places the payroll professional in a very difficult situation. We commend Representatives Christensen and Kim for having taken the initiative to introduce legislation that could make great strides in reducing the subjectivity and complexity of the legal test for worker classification.

We also commend Senator Nickles for his proposal to clarify section 530 of the Revenue Act of 1978, which has been included in H.R. 3448, at section 1122. In recent years, section 530 has been as much a source of confusion as the common law test itself, not to mention a significant source of contention between taxpayers and the IRS.

Briefly, section 1122 would modify section 530 in several important ways. First, to qualify for the industry practice safe haven, it would not be necessary to show that any more than 25 percent of an industry treated its workers as other than employees. The provision would also clarify that, to be long-standing, an industry practice need not have been continued for more than 10 years and that employers in industries created after 1978 can qualify for relief. APA strongly supports both of these changes.

Second, section 1122 would require Internal Revenue agents to provide taxpayers with written notice of the availability of relief under section 530 before or at the commencement of an audit of an employer's worker classification practices. Many small employers do not have the resources to hire tax counsel and thus may be unaware of all of the legal avenues available to them. As an "off-Code" provision, section 530 can be quite difficult to locate. Accordingly, APA believes mandatory written notice of the availability of 530 relief is an excellent improvement to the statute.

Despite APA's generally strong support for the Nickles proposal, we are concerned that this provision should <u>not</u> be treated as a permanent solution to the problems caused by the vague and confusing "20-factor test." However, much of the current pressure from taxpayers to simplify the worker classification tests will be eliminated if Congress enacts the proposed version of section 530(e)(3), "Availability of Safe Harbors." That section states: "Nothing in this section shall be construed to provide that subsection (a) only applies where the individual involved is otherwise an employee of the taxpayer." This section is designed to end a long-standing controversy between the IRS and employers about when section 530 applies. The IRS maintains that section 530 applies where workers who are <u>employees</u> have been misclassified by their employer. Taxpayers have maintained that section 530 relief should be available as a short-cut alternative to determining whether a worker is an employee or an independent contractor. Section 530(e)(3) supports that "short-cut" approach. Stated

differently, the use of section 530 would <u>not</u> provide any indication of whether or not a worker is an employee. Companies could simply elect section 530 if they meet the criteria set forth there, and their payroll tax audit over worker classification issues would end.

APA urges Congress to realize, however, that section 530 alone does <u>not</u> end the confusion for <u>workers</u> (or payroll professionals) over how the workers should be classified. The <u>company's</u> audit may have been stopped more quickly, but the workers themselves are still confused over whether they should be classified as independent contractors or as employees. As independent contractors, they are subject to SECA taxes, required to establish their own benefit plans, ineligible for unemployment benefits, but permitted to take business expense deductions without the limitations applied to employees. As employees, they are required to pay only the employee share of FICA taxes, can participate in the company's benefits plans, and qualify for unemployment benefits. Workers still need an objective, administrable definition of "employee" versus "independent contractor" to help them resolve this confusion permanently.

The Senate leadership has proposed an additional amendment to H.R. 3448, which would further reduce confusion and add simplicity for payroll professionals. Briefly, the Amendment would codify section 530, extend section 530 relief to workers, and, apparently, extend relief to all tax consequences of worker classification. That is, if an employer had a reasonable basis for treating its workers as other than employees, such workers would be considered as other than employees throughout Title 26 of the United States Code. This emminently sensible approach would be welcome relief to payroll professionals and is strongly supported by APA.

RECOMMENDATIONS

In summary, APA recommends the following:

- replace the common law "right to control" test with a simple, objective statutory test for classifying workers as employees or independent contractors to ease the burdens on both information reporters and the IRS;
- clarify section 530 of the Revenue Act of 1978 in accord with section 1122 of H.R. 3448; and
- extend section 530 relief beyond employment taxes to the entire Internal Revenue Code in accord with the Senate leadership amendment.

APA would like to thank the Subcommittee for holding hearings on this important issue and for affording organizations like ours the opportunity to be heard. We would also like to thank Representatives Christensen and Kim and Senator Nickles for their foresight and initiative in attempting to solve the worker classification problem. APA is committed to assisting in any way it can in the effort to simplify the law in this area and will be happy to answer any questions that may arise.

Respectfully,

Director of Government Affairs
American Payroll Association

Kyn Kelley

Statement of
American Pulpwood Association Inc.
Independent Contractor Association of America, Inc.
Independent Insurance Agents of America
National Association of Independent Insurers

Employment Classification Issues submitted to House Ways and Means Oversight Subcommittee July 8, 1996

The American Pulpwood Association, Inc., the Independent Contractor Association of America, Inc., the Independent Insurance Agents of America, and the National Association of Independent Insurers represent members directly affected by employment classification issues. On behalf of our members companies, we respectfully submit the following comments on worker classification issues and request that they be included in the hearing record. Our associations are strongly supportive of the current-law protections concerning the classification of workers as independent contractors. Over five million Americans work as independent contractors and nearly one-third of all companies use independent contractors to some degree. Literally tens of thousands of businesses and individuals rely on the current statutory protections in structuring their independent contractor relationships. Our industries are no exception.

We urge the committee to proceed with caution when considering changes to independent contractor status. Specifically, we urge the committee to ensure that

- · the current Section 530 protections are not displaced;
- other statutory independent contractor provisions are preserved;
- the 20-factor common law test is retained as a fall-back test for workers who do not qualify for safe harbor protection; and
- · mandatory or optional withholding is not imposed on payments to independent contractors.

Numerous disputes arise each year between taxpayers and the Internal Revenue Service (IRS) over the classification of workers. However, as is evidenced by a close examination of the testimony of the witnesses before the committee, the problems experienced by taxpayers over worker classification issues in general stem from difficulties arising from enforcement activities and not from the law itself. Many of the cases arise not from uncertain applications of the current law, but rather from overzealous efforts on the part of the IRS to reclassify workers. These actions are clearly demonstrated by the inclusion as part of the IRS's Employment Tax Examination Program a component which targets businesses with assets of less than \$3 million for worker classification challenges. Admittedly problems exist with the enforcement of the independent contractor law, however, it stands as a testament to the success of the current law that millions of Americans are independent contractors and many of our nation's businesses use their services.

Section 530

Section 530 was enacted in 1978 in response to over zealous efforts by the IRS to reclassify workers as employees. Our associations were active participants in the coalition of business interests which was instrumental in securing passage of this important legislation. It provides businesses and independent contractors with a sense of security and safe harbor protections. Each of the safe harbors — administrative or judicial precedent; prior audit; industry practice; and other reasonable basis — are important for specific reasons.

Judicial or Administrative Precedent

Reasonable reliance on administrative or judicial precedent protects businesses that have relied on good faith interpretations of applicable precedents when classifying their workers. Taxpayers may base their reliance on judicial precedents, published rulings, or technical advice or letter rulings with respect to the taxpayer. This safe harbor provision enables businesses that comply with the

requirements of Section 530, including issuing 1099's and consistently treating similarly-situated workers, to engage independent contractors without fear that the IRS will later interpret the precedent differently and call their classifications into question.

Prior Audit

Businesses are protected from repeated IRS investigations by the prior IRS audit safe harbor. The provision, enacted to protect businesses from repetitive IRS audits involving the same workers, allows taxpayers to continue to classify workers as independent contractors with a sense of certitude if the IRS failed to raise an employment tax issue on audit, even if the audit was not for employment tax matters. Eliminating or limiting this valuable safe harbor would subject businesses, once again, to repeated harassment by the IRS. The Senate Finance Committee included a modification to the prior audit safe harbor during its consideration of H.R. 3348, the Small Business Job Protection Act of 1996. Under the proposal, taxpayers would not be permitted to rely on audits commenced after December 31, 1996, unless the audit specifically included an examination of the treatment of workers for employment tax purposes.

Our associations oppose such a modification in the prior audit safe harbor. Restricting the prior audit safe harbor to employment tax audits involving the classification of workers would leave taxpayers open to IRS challenges to their worker classification, even though the IRS had conducted prior audits and was aware of the taxpayer's practice. As a result, taxpayers could be made liable for reclassification and retroactive employment tax liability in cases where the IRS was aware for years that the business was classifying the workers in question as independent contractors and had not raised an issue. While the modification was proposed in response to criticisms that the businesses would assert prior audit protection even for audits of totally unrelated issues, we believe these concerns are simply unfounded. The requirement that the reliance be "reasonable" effectively prohibits taxpayers from asserting protection for completely unrelated audits. If the committee chooses to clarify the prior audit safe harbor so that the above-noted potential abuses are explicitly proscribed, we would suggest the language of the provision be altered to read that Section 530 protection is available if reasonable reliance was based on "any prior audit except one where the IRS would not be reasonably expected to have considered an employment tax issue."

Long-standing Industry Practice

Taxpayers are accorded Section 530 protection if they relied on a long-standing recognized practice of a significant segment of the industry as a basis for classifying workers as independent contractors. This industry practice safe harbor provides critical protection for taxpayers in industries where workers have always been classified as independent contractors, but no administrative or judicial precedent has been established. Over the years, questions have arisen in applying this safe harbor regarding the interpretation and application of the terms "long standing practice" and "significant segment of the industry." Section 530 does not stipulate a specific time period in order to qualify as long-standing, neither does it provide a clear standard for what constitutes a significant segment of a taxpayer's industry. The Finance Committee also included modifications to the industry practice safe harbor in its changes to H.R. 3348. The Senate provision would clarify that 10 years constitutes a long-standing practice and that industries begun after 1978 can meet the long-standing standard. In addition, the provision would provide that taxpayers would be required to show that no more than 25 percent of their industry follow a specific practice in order to satisfy the significant segment of the industry requirements. In both instances, the numeric standards are intended to provide a safe harbor and, based on a taxpayer's particular facts and circumstances, lesser percentages of the industry or shorter periods of time could qualify for the Section 530 protection. Acting Treasury Assistant Secretary for Tax Policy Donald Lubick has informed the committee that the IRS is working to develop administrative guidance to be released later this year to stipulate that industry practices in place for 10 years would be presumed to be long-standing and the long-standing practices could exist in industries established after 1978. We support these modifications and believe that the thresholds are appropriate and will reduce the number of taxpayer disputes with the IRS in which the Service has applied unreasonable standards.1

The IRS has argued that significant segment of the industry means more than 50 percent. In re Bentley, 73 AFTR2d No. 94-667 (Bkrtcy, E.D. Tenn. 1994).

Other Reasonable Basis

Finally, the other reasonable basis safe harbor is invaluable to those businesses that have sound and justifiable grounds for classifying workers as independent contractors but do not qualify for one of the statutorily prescribed safe harbors. The courts have provided a constrained interpretation of this safe harbor and current law in this area should not be disturbed.

Section 530 has and continues to serve a useful purpose in stopping repeated taxpayer audits and ensuring fairness. We strongly urge the committee not to disturb the protections currently afforded under Section 530, except as noted above.

The Common Law Test

The determination of worker status for Federal tax purposes is generally made under a common-law test. The common-law test developed by the IRS from court cases and rulings include 20 factors which may be examined in establishing whether an employer-employee relationship exists with the relative importance of each factor determined based on the facts and circumstances of each particular case.

The common-law test is essential for taxpayers that may not qualify for one of the safe harbor provisions. In today's ever changing economic environment, it would be virtually impossible to construct safe harbor provisions that would cover all of the types of services that are now or may be offered in the future. Services provided today would have been unimaginable a few short years ago. For this reason, it is imperative that, regardless of modifications or expansion of the current harbors, the common-law test stand as the test of last resort. We exhort the committee to preserve the sanctity of the 20-factor test.

Withholding

Many of the proposed modifications affecting independent contractors will result in significant revenue losses to the U.S. Treasury. Proposals have been made by the General Accounting Office and others to impose withholding requirements on payments made to independent contractors. Withholding would be devastating to the viability of independent contractor status and we were pleased that during the committee's hearings Rep. Christensen rejected the idea of either mandatory or optional withholding as a revenue offset.

Withholding requirements would impose costly and time-consuming recordkeeping burdens on service recipients and would place independent contractors at a competitive disadvantage vis a vis their competitors operating in other forms. Under current law, employers are required to withhold income and employment taxes from payments of wages and employees are required to file withholding allowance certificates with their employers. In accordance with proscribed tables and computational procedures, employers compute the correct amount of withholding based on the withholding allowance claimed, the taxpayer's wages and the frequency of payroll payments. Withholding on payments to independent contractors are not subject to withholding, however, service recipients are required to file information returns for each payee receiving payments totaling \$600 or more during the calendar year.

Withholding would require independent contractors to file withholding allowance certificates with each service recipient and service recipients would be forced to compute and remit withholdings on payments made outside the business' normal payroll system and deposit cycle. Significant problems would arise if withholdings were imposed on payments received from service recipients, even if a uniform rate were imposed. Service recipients would still face the problems associated with withholdings which occur outside their normal deposit cycle and independent contractors would be burdened with uneven and widely varying effective withholding rates.

While withholding amounts may be computed with a relatively high level of certainty for wage earners, the financial impact of withholding would vary greatly depending on the contractor's net profit as a percentage of gross revenues. In the case of wage earners, net income is generally equal to, or very near, 100 percent of wages paid; however, large variances of net income as a

Internal Revenue Code Section 3402.

percentage of gross revenue exist both within and among industries. For example, two independent contractors operating in the same industry may experience vastly different profit margins for a variety of business reasons. If say a five-percent withholding rate were imposed on payments to both independent contractors the business with a net profit margin of 10 percent would be more severely impacted than the similar business with a 50 percent net profit margin. In the first case, withholding five percent from the business' fees would result in 50 percent of the contractor's net income being retained, while his competitor would face an effective withholding of only 10 percent. As a result, the first business would face cash flow constraints and be placed at a significant competitive disadvantage.

Additionally, singling out independent contractors for withholding would place individuals operating in this form of business at a disadvantage relative to their competitors operating in other forms, such as corporations, partnerships, sole proprietorships and limited liability companies. Service recipients contracting with these businesses would have no withholding responsibility pursuant to payments for services received. However, relationships with independent contractors would expose the service recipient to burdensome administrative withholding duties, making them more reluctant to engage in these transactions. To single out independent contractors for withholding would impede their ability to attract and retain clients and erode their competitive position in the marketplace.

For the foregoing reasons, our associations remain steadfast in our opposition to any effort to impose withholding in any form on payments made to independent contractors.

Finance Committee Modifications

In addition to the above-referenced modifications, the Finance Committee made a number of additional changes to provisions affecting independent contractors. The provisions include language clarifying that a worker does not have to otherwise be an employee of the taxpayer in order for Section 530 protections to apply. Although nothing in the language or legislative history of Section 530 requires that a worker be determined to be an employee under the common-law test before Section 530 relief is made available, the IRS adopted the position that such a determination be made first. While most court decisions have not explicitly addressed this issue, those which have considered the question directly have ruled that Section 530 relief is available irrespective of the worker's status under the common law test. Despite these holdings, the draft of the new IRS worker classification training guide released earlier this year indicated that there must first be a determination of employee status before agents could apply Section 530 relief. The Finance Committee action would reverse this position and codify the decisions of the courts. Our groups applaud the Senate's action and urge the committee to follow the Finance Committee language.

The Senate panel also included provisions requiring workers and service recipients to sign agreements acknowledging that the worker will not be treated as an employee for employment tax purposes in order to receive Section 530 protection. We do not oppose this requirement. In addition, under the modified provisions, the IRS would be required to provide taxpayers with written notice of the provisions of Section 530 at the commencement of any audit involving worker classification. IRS Commissioner Margaret Richardson has advised the committee the final version of the IRS training manual due out this fall will also include this requirement. We support this requirement and urge the committee to codify the mandate.

Finally, the Finance Committee included changes to shift the burden of proof to the IRS with respect to all aspects of Section 530 except for determining whether the taxpayer had any other reasonable basis for treating a worker as an independent contractor, if the taxpayer can establish a prima facie case that it was reasonable not to treat a worker as an employee for purposes of Section 530. The burden of proof will shift only in the case of taxpayers who fully cooperate with "reasonable" requests by the IRS for information relevant to their classification of workers. Although we believe that the IRS should bear the burden of proof, we are concerned that the

Lambert's Nursery and Landscaping Inc, v U.S., 894 F.2d 154 (5th Cir. 1990); J&J Cab Service Inc. v. U.S., 75 AFTR2d No. 95-618 (W.D. N.C. 1995); Queensgate Dental Family Practice Inc. v U.S., 91-2 USTC No. 50,336 (M.D. Pa. 1991).

provision as worded could result in taxpayers being forced to incur significant costs in producing inordinate amounts of information — perhaps of dubious relevance — in order to be deemed cooperative. The requirement could also result in a more protracted administrative consideration of the issue. If the committee includes language to shift the burden of proof, we urge the members to include report language limiting the scope of compliance necessary for a taxpayer to be deemed cooperative.

Treasury Department Recommendations

At the committee's June 20th hearing on employment classification issues, Donald Lubick, on behalf of the Department of Treasury, requested four specific legislative changes related to independent contractor status. Mr. Lubick called on the committee to enact legislation permitting the IRS to forgive prior year employment tax liabilities in certain circumstances, to provide access to tax court, to permit Treasury to issue guidance under Section 530 and to increase certain information return penalties.

Forgiveness of Prior Year Employment Tax Liability

Treasury requested that the committee permit the IRS to forgive prior year employment tax liabilities in certain circumstances for taxpayers who prospectively reclassify their workers. Treasury proposes that, in the case of taxpayers who are determined to have misclassified their workers, but who meet the Section 530 reporting requirements and have a reasonable argument that they meet the consistency and reasonable basis requirements, the IRS be empowered to forgive prior year's employment tax liabilities. Treasury believes that taxpayer's fear of retroactive employment tax liability, rather than the prospect of future responsibilities, presents the greatest roadblock to IRS efforts to settle disputes involving worker classification. Our associations do not oppose this proposition, however, we believe it will be important for Congress to exercise effective oversight to ensure that the IRS does not abuse the authority and coerce taxpayers into reclassifying workers who are legitimately classified as independent contractors.

Access to Tax Court

Earlier this year, the IRS established procedures for taxpayers to request early referral to Appeals of any developed, unagreed issues arising from an examination under the jurisdiction of the district director. Issues which, if resolved, could reasonably be expected to result in speedier resolution of the entire case and which the taxpayer and district director agree should be referred to Appeals would be eligible for the new program. Employment tax issues, including disputes over whether a worker is a common-law employee or independent contractor, or whether Section 530 applies, will be eligible for the early referral program on a one year test basis.

Additionally, Mr. Lubick has requested that the committee enlarge the jurisdiction of the U.S. Tax Court to cover cases involving worker classifications for employment tax purposes on a prospective basis. Treasury believes providing taxpayers access to Tax Court will result in quicker and lower cost resolutions. Tax Court judges have substantial experience resolving tax cases involving similar issues and, in many instances, are able to resolve suits without requiring the business to retain counsel. Our groups applaud the IRS efforts to promote referral of cases to early Appeal and support expanding access to the Tax Court. Taxpayers incur significant expense in independent contractor disputes in large part due to the protracted settlement process. Even in cases where the taxpayer prevails, they have often spent tens of thousands of dollars and countless man hours defending their position through audit, appeal and litigation. Providing speedier resolution at the IRS level and greater access to independent judicial review will relieve taxpayers of some of the effects, financial and otherwise, of these lengthy and costly disputes.

Section 530 Guidance

Current law precludes the IRS from issuing revenue rulings or regulations to provide clarification under Section 530. Treasury believes that it would be possible to improve understanding of and compliance with the common law classification standards if IRS were permitted to issue revenue ruling or other guidance. The revised IRS training manual draft attempts to clarify for agents that

Rev. Proc. 96-9, 1996-2 I.R.B. 15.

the common law test refers to the ability of a service recipient to "direct or control" a service provider and that the 20 factors are merely criteria used to evidence whether or not the test is satisfied. Lubick advised the committee that the Administration would like to communicate their positions to not only agents, but taxpayers as well, through more formal guidance. We strongly urge the committee to reject the IRS's request for authority to issue guidance under Section 530. The IRS has demonstrated through its words and actions that it should not be entrusted with this authority. Despite court decisions to the contrary, the IRS continues to assert positions in litigation and in training manuals which are clearly contrary to congressional intent. We believe extending authority to issue guidance in this area would lead to more, not less, disputes between taxpayers and the Service.

Information Return Penalties

The Treasury has also requested that the committee provide increased penalties for service-recipient failures to file timely and correct information returns. Specifically, Lubick encouraged the enactment of the penalty provisions included in the President's Fiscal Year 1997 budget proposal. Businesses are required by law to file an informational report with the Internal Revenue Service for each service provider to whom it makes payments which in aggregate total \$600 or more per year. These reports must include the name, address and taxpayer identification number of the service provider, as well as the amount of the payments.

Under current law taxpayers who fail to timely file correct information returns, such as a Form 1099, are subject to a penalty of up to \$50 per return, up to \$250,000 during any calendar year. President Clinton proposes to increase the penalty for failure to file these information returns to the greater of \$50 per return or five percent of the amount required to be reported. Our groups oppose this proposal.

The proposed penalty modifications would be particularly burdensome and costly for property-casualty insurers. Property-casualty companies make tens of millions of payments each year on behalf of policyholders to third-party service providers, such as auto repair shops, towing services, construction companies, doctors, and hospitals. Typically, the insurer has no role in selecting the service provider or control over the information provided by the third-party. Insurance personnel generally do not contract with the service provider. Such arrangements clearly are not the target of efforts to reform independent contractor status and the nature of the arrangements make it extremely difficult for insurers to obtain timely and accurate taxpayer information. Nevertheless, the President's proposal would punish an insurer for an inaccurate report that occurs through no fault of its own. This proposal would have significant and detrimental consequences which extend well beyond the scope of worker classification issues. We strongly urge the committee to reject this proposal both in the context of independent contractor reform and in the broader context of budget reconciliation.

Recommendations for Reform

As the committee considers modifications to provisions relating to independent contractor status, our groups urge members to consider the following recommendations.

Fee Recovery Provisions

One of the most onerous aspects of independent contractor disputes is the financial toll it takes on taxpayers who defend their position. Many businesses are not in a financial position to engage the IRS in lengthy and costly legal battles to defend their position. These taxpayers are often forced into agreeing to reclassifications even though they know their position is sound. Under current rules, in order to qualify for attorney fee reimbursement taxpayers must show that the IRS's position is not substantially justified. In addition, recoverable fees are limited to those incurred in connection with actual litigation and the law imposes an hourly cap on these fees. As a result, for taxpayers who are unable to front the associated legal costs, appealing or litigating to prove their position is often not a realistic possibility.

Although the pending Taxpayer Bill of Rights 2 legislation contains a fee recovery provision, the current language which would shift the burden of proof to require the IRS to demonstrate that its position in a case in which the taxpayer prevailed was substantially justified does not apply to Section 530 cases. We encourage the committee to expand this fee recovery provision to independent contractor issues. We also urge the committee to modify the language to provide that a taxpayer who responds to an IRS challenge concerning its classification of workers by claiming eligibility for protection under Section 530 and is subsequently held by the courts to qualify for Section 530 protection be entitled per se to recover all of his or her costs incurred in defending against the IRS challenge, including costs incurred during the IRS's administrative consideration of the issue.

Section 530 Consistency Requirements

One of the most onerous and unforgiving requirements of Section 530 is the requirement that the taxpayer must not have treated any worker holding a substantially similar position as an employee for purposes of employment taxes for any period since 1978. In order to receive Section 530 protection, therefore, a taxpayer must have and continue to classify all substantially similar workers as independent contractors. Thus, a company that has treated even one of a type of worker as an employee is forever precluded from obtaining Section 530 protection with respect to that type of worker.

Despite the very valid objective of the consistency requirement, its application in many cases has produced harsh and unjustified results. As an example consider the case of two businesses competing in the same industry and utilizing similar workers performing comparable functions. One business began in 1980, a pioneer in the industry, initially classified workers as employees, but almost immediately converted the "employees" to independent contractor status. Under the consistency rules, this business would be forever precluded from obtaining Section 530 protection with respect to those workers. The second business entered the market in 1990 and classified its work force as independent contractors, as was the practice of the industry. Unlike its competitor, the new business would be eligible for Section 530 protection. However meritorious the objective of the consistency requirements, we find the result of its application in this and like situations unjustified and inequitable.

To remedy this situation, we urge the committee to modify the consistency requirements so that it would not operate as an absolute perennial bar. We urge the members to modify the consistency requirement so that for purposes of determining whether a taxpayer satisfies the requirement 1) a taxpayer's classification of a de minimis number of workers as employees during a taxable year would not be taken into account, and 2) a taxpayer's classification of workers as employees made more than five years prior to the taxable year at issue would not be taken into account. These minor modifications would preserve the general objectives of the consistency requirements without placing taxpayers at a permanent competitive disadvantage.

We appreciate the opportunity to present our views on proposed legislative changes affecting employee classification and to make specific recommendations for reform. As we have previously stated, the underlying problems inherent in employee classifications stem from enforcement and not from the law itself. We urge the committee to proceed with caution and to safeguard the Section 530 protections and to retain the common-law test. We believe the modifications we have endorsed and proposed will go a long way to solving the issues the committee has raised without disrupting a system on which thousands of workers and service recipients rely.

Respectfully submitted,

Julie Leigh Gackenbach
Director of Government Relations

National Association of Independent Insurers 444 North Capitol Street, N.W., Suite 801

Washington, D.C. 20001

The American Pulpwood Association, Inc.

The American Pulpwood Association Inc. is a nationwide nonprofit trade association responsible for issues that surround the safe and efficient harvest and transportation of forest products from the woods to the mill. APA members include the nation's pulp and paper mills, wood dealers, and independent logging contractors who harvest and transport pulpwood and timber, and equipment companies that manufacture pulpwood and timber harvesting and processing equipment.

The Independent Contractor Association of America, Inc.

The Independent Contractor Association of America, Inc. (ICAA) is a national association dedicated to the preservation of independent contractor status. ICAA members consist of individuals working as independent contractors and businesses that purchase services from independent contractors. ICAA currently represents over 3,000 independent contractors and business that engage independent contractors.

The Independent Insurance Agents of America

Founded in 1896, the Independent Insurance Agents of America (IIAA) is the nation's oldest and largest national association of independent insurance agents, representing a network of 300,000 agents and agency employees. Independent agents offer customers a choice of policies from a variety of insurance companies. Independent agents offer all lines of insurance - property, casualty, life and health.

The National Association of Independent Insurers

The National Association of Independent Insurers (NAII) is a trade association representing 555 property and casualty insurance companies. The NAII was founded 50 years ago on the principles of open competition and pricing flexibility in the insurance industry. Our members range in size from the very largest national writers to the smallest one state writers. Among our members are mutual and stock companies and reciprocal exchanges. Their marketing strategies range from providing the widest range of insurance products to those specializing in relatively few product lines. NAII members account for one-third of all property-casualty insurance premiums written in the United States.

STATEMENT OF KATHY FORD MONTGOMERY, KATHY FORD INTERIORS ON BEHALF OF THE AMERICAN SOCIETY OF INTERIOR DESIGNERS (ASID)

On behalf of the 30,000 members of the American Society of Interior Designers (ASID), I am pleased to have the opportunity to submit a written statement for the record to the Subcommittee on Oversight, Committee on Ways and Means, in support of H.R. 1972, a bill introduced by Rep. Jon Christensen (R-Neb.).

ASID would like to thank Chairman Nancy L. Johnson (R-CT) for holding this hearing to provide a forum for discussion on this important issue.

As National President-Elect of the American Society of Interior Designers (ASID) and owner/principal of Kathy H. Ford Interiors, Lubbock, Texas, I am keenly aware of the effect of the status of independent contractors on the entire design-build industry, including interior design businesses.

ASID's membership includes interior design practitioners, as well as manufacturers and suppliers of products which interior designers specify. As the largest interior design organization, ASID represents a broad cross section of the design industry, including contract and residential designers, self-employed individuals, and large and small businesses.

As the subcommittee is aware, the independent contractor issue drew considerable attention at the third White House Conference on Small Business in June 1995. Interior designers were among the participants at that conference.

ASID supports the Christensen bill along with the other organizations that belong to the Independent Contractor Coalition. Many of our partners in the coalition represent trades and industries which provide services as independent contractors on design projects. We welcome H.R. 1972, as it establishes an objective, three-part test for determining whether an individual is an independent contractor or employee.

I started my firm 18 years ago and specialize in design for health care facilities and corporate offices. Today's business environment demands that my business run "lean and mean" on overhead costs; yet, thanks to new technology, we are able to work with clients anywhere by using independent contractors in different cities, wherever the client is located.

The greatest operating cost in an interior design business is the cost of labor. To remain profitable, firms must outsource. Using independent contractors also enables us, as designers, to assemble the best and most suitable team possible for each project. Independent contractors may be specialists in aspects of design such as lighting, custom cabinetry, environmental design, life cycle analysis or ADA compliance review. Or independent contractors may offer support skills in Computer Aided Design (CAD) drawings or project supervision to ensure that the design firm's clients are well served.

I would not be able to maintain my firm's competitiveness if I had to add these resource contractors to my payroll. Different jobs require different resources. Part of my competitive advantage is having the flexibility to identify and use the best resource contractors for each client's needs. These independent contractors make it possible for me to take on large projects that I cannot handle with my small staff.

The independent contractors my firm uses are small businesses like myself. They are proud of their companies and struggle with many of the same issues my design firm handles. They do not want

to be on my payroll or work as my employee. They are accustomed to competing for jobs and working as subcontractors in the design/build industry. They like the independence of being a small business owner, and they market their specialty to stay in business.

Today's students and entry-level professionals are taught that in the business world they are entering they should consider becoming independent contractors, outsourcing work or becoming specialists who will then contract out to many different firms, such as mine. Interior designers are offered diverse training and experience and may choose a general or specialized business. In either case they are likely to be involved as, or with, independent contractors in their future.

It is very difficult for the small business owner to make a profit and grow his or her business. Using independent contractors to perform various services is a long standing practice among small businesses, yet the IRS has never fully accepted that reality. As a result, we live with the fear that the IRS will arbitrarily determine that these individual contractors, whom we have engaged, are not independent contractors, but employees for whom federal withholding tax, FICA, and FUTA payments are owed. The loss of ability to work as an independent contractor or use one would make it practically impossible for small businesses to maintain any sort of profitability.

We are not suggesting that guidelines are not needed. Small interior design firms who have faced an IRS audit with regard to independent contractors can attest to the need for more clarity.

ASID believes that legislation which clarifies the independent contractor classification, fairly written, would go a long way toward making certain that the independent contractor status is not abused. We believe H.R. 1972 is that kind of common sense approach to clarify who is an independent contractor.

Before the

SUBCOMMITTEE ON OVERSIGHT COMMITTEE ON WAYS AND MEANS U.S. HOUSE OF REPRESENTATIVES

June 20, 1996 Washington, DC

Statement for the record of

AMERICAN TRUCKING ASSOCIATIONS, INC.

on

INDEPENDENT CONTRACTOR/EMPLOYEE TAX CLASSIFICATION ISSUES

- The trucking industry has long been a source of opportunity for individuals wishing to go into business for themselves. Because an individual who does <u>not</u> wish to be an independent contractor nearly always has the opportunity to work elsewhere as an employee, it is rare to find trucking companies who have inappropriately classified workers. The industry has repeatedly been supported in its interpretation of the law: some of the most important case law defining who is an independent contractor involves the trucking industry, dating back to Supreme Court decisions in the 1940s.
- o Because the proper classification of a worker necessarily depends heavily on the particular facts of that worker's arrangements with a service recipient, statutory definitions or standards are unlikely to end controversies. Instead, the solution lies in giving agents and taxpayers a clear understanding of how to apply existing law.
- o Recently, the National Office of the IRS has taken some positive steps to improve fairness and consistency in worker classification. For instance, the draft training manual for field offices and agents handling classification requests shows a refreshing balance, clarity and awareness of what factors should or should not be relevant for classification in today's business environment. The "market segment understanding" initiative also shows promises of developing appropriate occupation-specific standards in cooperation with affected industries. We think these approaches will deliver more benefits than legislation that inevitably introduces terms and concepts subject to further litigation. If legislation is adopted, it should broaden consistency by applying to all income and unemployment tax purposes.
- The IRS has unfortunately chosen to force service recipients to become tax collectors rather than improving compliance directly. A fairer way to improve compliance is for the IRS to use the information it already obtains, by requiring individuals with income subject to reporting on Form 1099-Misc to list these receipts separately; that would allow efficient matching of 1099s and tax returns, as the IRS has successfully done with dividends and interest.

I. ATA Represents an Industry with Thousands of Independent Contractors

The trucking industry includes more than 350,000 companies, of which 88% are small businesses. The American Trucking Associations (ATA), the national trade association of the trucking industry, has member companies in every state and business segment. ATA is a federation comprising 38,000 trucking companies and suppliers that belong directly to ATA or its 51 state affiliates and 14 specialized national affiliates. ATA includes motor carriers of all sizes and types, ranging from single owner-operators to major companies that

employ drivers, contract with owner-operators, or both. Classification of workers as employees or independent contractors is a major concern in trucking, and we appreciate the chance to offer our views on this issue.

Independent contractors play a vital role in several segments of trucking. Independent contractor drivers are small businesses that buy or lease and operate their own equipment and pay virtually all of the costs of such businesses, including fuel, maintenance, labor, bookkeeping and taxes. Such businesses are specifically recognized by Congress in the Interstate Commerce Act and regulations of the Federal Highway Administration and Surface Transportation Board. As independent business people, they make their own decisions as to what shipments to contract to handle, what routes to take, and what business and personal expenses to assume.

II. Current Law Protections Should Be Retained

Despite complaints and "horror stories" regularly trotted before committees that have held hearings on employee classification, there are many industries in which the current, common law approach to classification works well. For instance, in trucking there is a long history of case law, including Supreme Court decisions, establishing conditions under which drivers are independent contractors. ATA has worked hard to educate our members regarding classification criteria. We have also worked with IRS and Treasury staff on a number of initiatives to improve certainty and compliance.

"Current law" does not imply an absence of guidance. The IRS issues hundreds of private letter rulings and technical advice memoranda per year, and courts continue to rule on employment classification cases. In fact, it is the very continuity of current law that makes it the best solution for an inherently complicated problem.

III. Improving IRS Guidance and Enforcement

The quality of IRS guidance and enforcement can be improved without changing the underlying law. Recently, the IRS has taken steps that hold some promise of improving the classification process.

The most significant step is issuance of a training manual for agents. The draft of this manual, which was wisely made available for public comment (and has received over 60 comments), did a good job of presenting the issues and law in a clear, well-organized fashion. It also provided a realistic view of what factors should be disregarded or downplayed in classifying workers. For instance, use of a uniform or logo on a vehicle is not an indicator of employment status, as the manual acknowledges. Nevertheless, the manual can be strengthened. For example, ATA has recommended that the manual should allow examiners to make a section 530 determination before going through the common law factors, and that efforts by companies to assure compliance with requirements of other government agencies or to pass along feedback from customers should not jeopardize independent contractor status.

A second positive initiative has been the "market segment understanding" dialogue that the IRS has engaged in with several industries, including household goods movers, to come up with a shortened list of "critical" and "significant" factors that would demonstrate worker status. Unfortunately, the IRS has not had the internal unity or organization to conclude these discussions in timely fashion. Industry groups are showing understandable frustration with the lack of results after as much as four years of discussions. But we still believe an industry- and occupation-specific approach is a promising one. We hope the Committee will encourage the IRS to engage in more such dialogues and to conclude them promptly.

IV. How to Improve Compliance

A major reason that the IRS focuses so heavily on worker classification is that it believes that it is much easier to have payors withhold and remit tax than to get individuals to do so. Yet the Treasury Department noted in its 1991 report, "Taxation of Technical Services Personnel: Section 1706 of the Tax Reform Act of 1986", that compliance can be as high for some independent contractors as for employees.

The IRS has ignored its own success in boosting compliance from dividend and interest recipients. This success resulted from three measures: beefed-up reporting by payors, IRS matching of these reports against individuals' listing of each dividend and interest payor, and IRS letters to individuals asking them to pay tax on unreported income or to explain discrepancies.

ATA believes the same model would work with self-employment (independent contractor) income. In repeated meetings with Treasury and IRS officials we have urged two simple changes to Schedule C of IRS Form 1040 that would lead to a number of benefits for compliance:

- Require individuals to list their total self-employment income separately from other receipts.
- Require that they list the amount paid by each service recipient and the payor's name.

The IRS would then be able to match the total from Schedule C against the amounts the IRS had posted on the individual's master file. Where a discrepancy existed, the IRS could see which payors were omitted from Schedule C. The process would enable the IRS to target and resolve discrepancies much more efficiently and less intrusively than is presently possible. There would be no added burden for businesses or for individuals who are already reporting all self-employment income. These individuals are already creating a listing of payors (if they have more than one) for their own use and could readily include that list with their returns. No legislation would be required for the IRS to require and use this data.

V. Legislation

As noted, ATA believes that the combination of common law and section 530 provides a reasonable degree of certainty and protection for many taxpayers, both individual and business. Improved IRS training of its agents, application of section 530 first in audits, and agreements or "understandings" with industries regarding specific categories of workers would resolve many of the existing problems without new legislation.

Although ATA does not oppose legislative attempts to provide more objective standards for service recipients wishing to treat workers as independent contractors, we have some reservations. First, we fear that injecting undefined or imprecisely defined terms into the tax code will lead to the same sorts of controversies as now exist over whether a particular taxpayer qualifies for relief. Second, standards that must be applied worker by worker may require the business to obtain and keep more documentation than is currently necessary and to risk losing independent contractor treatment for those workers for whom paperwork is incomplete or missing. In contrast, under current law, a company can generally show that it treats workers "consistently" without having to provide documentation on each one. Third, we are worried about how the revenue loss from a bill would be offset. Companies that have not had a problem under current law are naturally apprehensive about legislation that would give them no further relief but might be paid for by cutting back the very protection they now rely on or by imposing new recordkeeping, reporting or withholding burdens.

If the Committee decides legislation is necessary, we recommend that it emphasize consistency among all federal taxes in applying a worker's classification. Currently, section

530 provides relief only from employment tax obligations. But the IRS takes the view that when a business qualifies for section 530 relief, the worker is nevertheless an employee for the business's pension and benefits income tax obligations as well as for individual tax considerations. In addition, states are free to classify the same worker differently from the federal government for the same unemployment tax. These results are illogical and incomprehensible for both the business and the individual. The Committee has jurisdiction over these issues, though not for the broader questions of defining employment status for other state taxes or for nontax purposes. For instance, Internal Revenue Code section 3304(a) already imposes 19 requirements on states seeking to have their unemployment laws qualify under the Federal Unemployment Tax Act (FUTA). Requiring states to adhere to an IRS determination of worker status for FUTA purposes would be consistent with these other requirements and would remove a trap for unwary businesses and individuals. (H.R. 510, introduced by Reps. Christopher Shays and Tom Lantos, includes such a provision.)

Any new statutory standards, as well as determinations under section 530 if that is to be amended, should apply for all tax code purposes, not just for employment tax. (H.R. 582, introduced by Rep. Jay Kim, and S. 1610, introduced by Sens. Kit Bond and Don Nickles, would achieve that result by applying to "this title", meaning the entire tax code title of the U.S. Code. In contrast, H.R. 1972, introduced by Rep. Jon Christensen, would apply only to the employment tax subtitle, as does current section 530.)

The Senate Finance Committee has reported out (as part of its version of H.R. 3448) several proposed modifications to section 530. Several of these are clearly worthwhile, such as applying section 530 without first making an employment determination, specifying that 25% is a safe harbor for defining "significant segment" of an industry and that 10 years (or less for newer industries) is a safe harbor for defining "long-standing". We believe the IRS could and should adopt all of these even without legislation, however. The bill's most controversial proposal would limit the prior audit safe harbor after 1996 to examinations that specifically covered workers doing similar work to those whose status is being challenged; some ATA members have expressed concern that it would be hard to get documentation from the IRS that workers' employment tax status had been examined and judged satisfactory unless the bill is strengthened in this regard.

There also have been proposals to increase penalties for failure to issue information returns (Form 1099-Misc) to independent contractors. Many penalties in the tax code have been increased in the past decade, yet both IRS officials and outside researchers have expressed doubt about the value of increasing penalties in general. We urge the Committee to seek evidence that a proposed penalty increase would be useful in boosting compliance before adopting it.

VI. Conclusions

Court cases have provided more than 50 years of interpretation of the common law regarding tax classification of workers. Section 530 of the Revenue Act of 1978 has been in place for nearly 18 years. Congress should be very cautious about undermining these approaches to classification. Instead, the IRS should be urged to keep working internally and with taxpayer representatives to improve clarity and consistency in applying current law. In addition, the IRS should focus on making use of existing information to bolster compliance instead of either turning legitimate independent contractors into employees for its own convenience or seeking new penalties. If legislation is adopted, it should apply for income tax and the state portion of FUTA as well as existing federal employment tax requirements.

STATEMENT OF ASSOCIATED BUILDERS AND CONTRACTORS

Associated Builders and Contractors (ABC) is a national trade association representing over 18,500 contractors, subcontractors, material suppliers, and related firms from across the country and from all specialties in the construction industry. ABC represents 80 percent of the nation's construction workforce. The association's diverse membership is bound by a shared commitment to the free enterprise system and the merit shop philosophy of awarding construction contracts to the lowest responsible bidder through open and competitive bidding. ABC appreciates the opportunity to offer the following statement for the record of the Committee's June 4, 1996, oversight hearing on worker classification issues, the problems concerning independent contractor classification under the tax code, and the pending legislation to simplify this system.

ABC is pleased with the Ways and Means Committee's commitment toward examining the current problems with regard to the Internal Revenue Service's (IRS) handling of classification of independent contractors. This has been a contentious issue in the construction industry, which provides significant opportunities for independent contractors but has to operate under a confusing framework of rules that inadequately address the classification of workers as employees or independent contractors. Much of the problems stem from a confusing tax code which provides no clear definition of an independent contractor. ABC strongly believes there needs to be a reasonable and workable law that can be enforced in an evenhanded manner by the IRS. ABC supports the legislation (H.R. 1972) introduced by Rep. Jon Christensen (R-NE), which will set fair and objective rules for determining who is an employee and who is an independent contractor.

The Value of Independent Contractors in Construction

Independent contractors often provide the perfect answer to a pressing need for special skills and know-how required for short term projects. The flexibility an independent contractor provides to a small, fledgling operation creates numerous advantages for all parties involved. This arrangement allows the independent contractor to have the freedom to choose his or her work schedule, a small business owner the flexibility to adjust staff demands with business activity, and the consumer the opportunity to benefit from a reasonably priced, quality product. ABC believes that employers should continue to be able to make sound economic decisions about the classification of individuals as employees or independent contractors. Lawful utilization of independent contractors provides a good source of labor for projects where the contractor does not need to exercise the type of control that would necessitate the hiring of an employee.

Small businesses, the backbone of the American economy, particularly benefit from this practice. In fact, many ABC members started running their own businesses by working as independent contractors. It is not unusual for these individuals to work as employees during regular hours and as independent contractors during off-hours and weekends. There is no better way to become established as a small business than to begin as an independent contractor.

For example, in the drywall business, independent contractors are used for very specific tasks such as framing and drywall hanging and finishing. They are small, insured contractors who move from job to job and company to company. They own their own trucks and their own tools. These contractors greatly value their ability to work independently. The mark of an independent contractor is that he can control how, when, and where he provides services — qualities greatly valued by many in the small business world.

The construction industry as a whole faces a unique problem due to its high number of transient and seasonal workers. Because of the cyclical nature of the industry, many businesses cannot afford to keep certain specialized trade craftspeople as employees. Sometimes, skilled craftspeople are needed several times throughout the year, but not enough to warrant full-time or even part-time employment. Having to place two or three extra employees on the payroll just to finish a short-term project places a significant and unnecessary burden on companies.

The 20-Factor Test

Under current law, taxpayers must use a 20-factor common law test to determine whether a worker is an employee or an independent contractor. The 20-factor test is controversial and cumbersome, as well as subjective, and often leads to disputes between the IRS and businesses.

Imagine the difficulty of a small contractor, not trained in the field of law, but merely wishing to engage the services of a worker for some project, in confronting those 20 factors.

The same common law, 20-factor test is used by the IRS to determine compliance. The IRS generally examines the classification of workers some time after the taxpayer has made its determination of the workers' classification and after the taxpayer has filed its returns. Thus, reclassification by the IRS can result in severe penalties in the form of back taxes and interest. ABC believes that Congress, and not the IRS, should define independent contractor status. By clearly setting out rules that encompass how an independent contractor is defined, Congress can protect those in the construction and other industries who find it mutually beneficial to utilize independent contractors.

HR 1972 would establish a three-part objective test for determining whether someone is not an employee. In order to qualify as an employee, the individual must meet all three parts which address the level of investment, independence, and existence of a written contract. The independent contractor and business being served must continue to comply with all the income reporting rules. The legislation does not eliminate the 20-factor test, but provides an alternative test for those who comply with income reporting requirements.

ABC believes this process will provide distinct, clear and objective criteria to establish who qualifies as an independent contractor. In the construction industry, the worker's own investment in training, tools, and equipment, the worker's ability perform services for several different people, and the contract under which the worker operates are critical to the determination of whether the worker is an employee or independent contractor. The control by the hiring party is one component, but similarly important is the independence of the worker, which has to be integrated with the appropriate level of instruction and control to properly sequence the work on a project. All subcontractors have to work in harmony, and therefore must work under a clear plan or schedule. A delicate balance must be struck to avoid misclassification of these individuals when they are simply carrying out their duty to build the project. The appropriate focus on investment, independence, and contracts will help clarify the decision and free individuals to enter into business arrangements of their own choosing, without fear of the IRS making subjective decisions to push them into a different category.

Misclassification of Independent Contractors

When considering the independent contractor issue, it is critical to distinguish between wrongful classification and misclassification. In construction, wrongful classification can result in a competitive edge. Those companies not paying employee taxes or workers' compensation can undercut the competition by offering lower bids. ABC in no way condones intentional misclassification by businesses who shirk their duties to society and their workers.

On the other hand, simple misclassification or failure to file a 1099 form can easily occur through administrative error. A penalty should not apply in de minimis circumstances where the taxpayer correctly issues information returns to most of its workers. Why should those who genuinely believe they are within the bounds of an admittedly vague law be treated in the same manner as those who purposefully violate that law to gain a benefit? Innocent businesses who have mistakenly misclassified a worker as an independent contractor can be subjected to back taxes that can literally bankrupt them.

The "safe harbor" provisions in Section 530 protect taxpayers from reclassification if there is a reasonable basis for treating workers other than as employees. This reasonable basis may come from published rulings, a prior audit, or industry practice. Section 530 recognizes that taxpayers must be able to rely on reasonable methods of classification without risking bankruptcy. The protections found in Section 530 are invaluable, especially to the construction industry with its long history of industry practice.

Conclusion

In addition to protecting past classifications, ABC believes it is time to clear up the confusion surrounding the 20-factor test for future classifications once and for all. A clean and simple test that recognizes the valuable role of independent contractors in the small business world would ease the

way of the contractor struggling with a classification and make it easier to identify wrongfully classified workers. ABC supports H.R. 1972, which will preserve the current, mutually beneficial industry practice of properly utilizing independent contractors, and eliminate the need for the enigmatic 20-point common law test and replace it with a far more simple and objective formula.

The value to our nation of strong relationships between small businesses and independent contractors cannot be overstated. This is true local empowerment which creates thousands of new small businesses every year. It is also a critical part of the equation for improving the lives of disadvantaged and minority Americans who are working hard to seize opportunities to start their own businesses. ABC thanks the Committee for the opportunity to provide this statement for the record and urges Congress to continue its efforts to clarify and simplify the U.S. Tax code dealing with worker classification.

STATEMENT OF ASSOCIATION OF ALTERNATE POSTAL SYSTEMS

The Association of Alternate Postal Systems is a trade association of door-to-door delivery companies. AAPS has approximately 120 member companies in 38 states who serve more than 35% of the total population of the United States with distribution services in competition with the U.S. Postal Service.

Our membership is comprised of approximately one third newspaper ownership, about one third free publication ownership and about one third independent ownership. Most AAPS members are small businesses. A few, certainly a small minority of members, are large newspapers located in major metropolitan markets, including the Columbus Dispatch, Sacramento Bee, Houston Chronicle and Orlando Sentinel.

Most of the advertising being distributed by AAPS members is saturation flyers. These are produced by grocery chains and major retailers such as Kmart, Wal-Mart and Sears. In addition, a number of member companies distribute monthly magazines such as Popular Science and Better Homes & Gardens. All member companies distribute occasional product samples for major food and cosmetic manufacturers. Most member companies also distribute phone books and community directories.

With few exceptions our member companies depend on independent contractors to perform the delivery of these materials. This has been the case for many decades. Throughout the years many AAPS member companies have experienced Internal Revenue Service audits of independent contractor applicability and procedures. Throughout the 1960s through the 1980s, most have been found by the IRS to be in compliance with applicable contractor laws and filing requirements.

However, it seems that in the past five years the IRS has been increasingly inclined to rule that businesses performing the same functions in the same ways are no longer able to so categorize their carriers. The infamous twenty question test tends to be unclear and it is subjectively and arbitrarily applied. A company no longer is able to ascertain what is necessary to comply, how many of the twenty questions they have to "get right," what their own personal IRS auditor will consider to be "enough" compliance.

No company going into a compliance audit has any idea whatsoever, based on the twenty question test, what may be considered by the auditor to be an independent contractor or what will be pronounced to be an employee. Furthermore, a number of companies have been assessed back taxes and penalties contrary to the safe harbor laws of section 530 of the Revenue Act of 1978.

One typical AAPS member company, a small Midwestern business which had been in existence for about 30 years, was recently audited by the IRS. The conclusion of that audit was that the independent contractors who have been performing the delivery activity all those years were really employees all along. The company was assessed more than \$250,000 in back taxes and penalties. I am personally familiar with this company and its ownership, and I can vouch for their integrity. These people play by the rules and are careful to comply with reporting regulations.

Even if this company was doing something in ignorance that would tend to support the IRS's conclusion that its carriers were employees (to my knowledge they were not), they clearly were eligible for safe harbor relief. The entire industry has a long history of utilizing independent contractors for its carrier force, and this long established practice has been repeatedly upheld in many past IRS audits of numerous companies. This particular company's record of reporting and the submission of 1099 forms was unquestionable. In every way this company was entitled to relief under the safe harbor laws. Yet the IRS concluded that in their case, somehow the safe harbor rules were not applicable.

However, the IRS has generously offered to waive the back taxes and penalties if they will only classify their carriers as employees in the future. When threatened with a quarter million dollar payment, they appear to have decided to do what most small businesses would do; they have told me that they will likely cave in to the blackmail in order to get the IRS off their backs. Throughout the process they have incurred substantial legal fees, and by reclassifying their contractors as employees they now face a new annual expense in the \$100,000 range.

These people were very agreeable to give me the details, but asked that their business name not be identified for fear that their settlement position with the IRS would be jeopardized. Like most American individuals and businesses, they fear getting on the wrong side of the IRS. If your committee would like verification of this incident, I would happily provide you with more specific information on your assurance that their identity be protected.

It is our opinion that the IRS is out of control. It appears that their objective is to convert every contractor situation that they possibly can into an employer/employee relationship. It is my observation that they chafe under the safe harbor "limitations" and that they routinely ignore them. By refusing to extend safe harbor relief, they use the threat of back taxes, interest and penalties to coerce compliance and to force settlements that are favorable to them.

Our member companies contract with tens of thousands of individuals all over the United States for delivery of their products. Moreover, our industry extends far beyond our own association's membership, consisting of a substantial number of small businesses in every state, virtually every community, and comprising a significant segment of the labor market. As small businesses trying to comply with government regulations, we need a more clear, concrete guideline than the obscure twenty question test. Further, we need better oversight of the IRS to assure that they properly apply safe harbor laws and any corrective legislation as Congress intends them to.

We enthusiastically support the proposed legislation, HR 1972, as a significant improvement. While we have some concerns that some of the wording might be mis-construed by the IRS, certainly the proposed legislation is a significant step in the direction of clarity. We urge the Committee on Ways and Means to recommend this legislation to the full House of Representatives.

Beyond this pending legislation, however, we urge the Congress to take whatever action is necessary to force the IRS to comply with both the letter and the spirit of this proposed legislation as well as existing law. The improvements contained in HR 1972 will have little positive effect if the IRS is allowed to simply ignore them as they have the safe harbor laws. While it is important that small businesses comply with the law, it is every bit as important that government (specifically the IRS) is in compliance with the law also. The IRS in numerous cases has chosen to ignore the safe harbor protection laws, and we urge Congress to take whatever corrective action is necessary to force compliance.

Sincerely,

Kenneth L. Bradstreet Executive Director, Association of Alternate Postal Systems

Statement of Tom Brewster before the Oversight Committee of the House Ways and Means Committee

June 20, 1996

Chairman Johnson and Ladies and Gentlemen of the Subcommittee:

I appreciate the opportunity to address this Subcommittee. My name is Tom Brewster. I am a Marine Corps veteran, and a retired Montgomery County Maryland government worker. I am here today to ask on behalf of caddies that you consider why they should be treated as employees by country clubs. I am here to tell you that because caddies are generally treated as employees for every other purpose, they should not be regarded by clubs as independent contractors—because clubs generally control the employment of their caddies, no basis should exist to provide them relief or shelter from employer tax obligations.

I am a recipient of the Francis Quimet caddie scholarship which paid for my college education. I have caddied at country clubs, and I have caddied on the LPGA, PGA, and Senior PGA tours. I am also the author of the most comprehensive caddie training manual used today. As a caddie for almost forty years, I have witnessed the lives of caddies in a number of different and often disturbing settings. I have seen caddies working in deplorable conditions, many relegated to waiting in boxes no bigger than an outhouse, not getting paid for this waiting time, but only when they're carrying a bag. I have seen the system work as it has for many years, essentially under the table, and without recognition by clubs or caddies that wages are being earned.

I have observed that in the various country clubs I have worked for over the years, country clubs and their members almost never issue 1099 forms to caddies. They claim nevertheless that caddies should be treated by the government as independent contractors without the benefits or privileges of the employment relationship. At the same time:

- they set the caddies hours and provide the place to work
- they require caddies to wear uniforms
- they provide training for the caddies
- they post caddies fees and in many cases publish them in club materials
- they appraise the caddies performance and control their assignment to club members
- most caddies work solely for one club and many work for years at a time
- the club provides the office or "caddie shack" where the caddies report and wait for bags to carry

clubs funnel the caddie fees through the monthly membership billing

Because caddies have almost always been regarded as independent contractors by country clubs, they do not receive any employment benefits, much less recognition that the legal benefits of employment apply to them, such as workers' compensation and unemployment benefits. Caddies are expected to be responsible for reporting their income, and paying their own Social Security and Medicare contributions. In practice, of course, this income is rarely ever reported, these contributions are never made, and everybody loses in the long run except for those employing caddies.

Caddies are integrated into a club's business operations by delivering to its members a service to members who play golf. Caddies spend more time one on one with a club's members who play golf, than anyone else at the club. Because caddies play such a very important role in club operations and are in fact controlled by the club in a multitude of ways, they should be considered employees of the club.

The IRS has recognized this issue in their recent audit of one of the most prominent private country clubs in the nation. Exhibit I. In their audit, they recognized the true relationship between a club and its caddies, and reclassified the club's caddies from independent contractors to employees of the club. Additionally, the IRS levied a substantial fine against the club for worker misclassification. This is causing the country clubs to stand up and take notice for the first time in history that their current treatment of caddies is, as they have always suspected, incorrect. It is also the reason that country clubs are supporting through association an interpretation of H. R. 1972, H.R. 582, and of Section 530 of the Revenue Act of 1978, that will sanction their treatment of caddies as independent contractors.

I must say that I am hoping to communicate to this Committee not only on my own behalf, but on behalf of a majority of caddies who are less fortunate then me. I am not the norm among caddies. The group I also hope to represent are referred to as "career caddies." These individuals generally have minimal education, and come from lower income backgrounds. More importantly, most of these individuals are unaware of their rights as employees and the benefits of an employment relationship. They are also unaware of the obligations that flow from self employment.

It is a mistake to think of the caddie as a young teenager taking on a casual temporary job. While it is true that most caddies start out carrying a bag as youths, many of them stay for the rest of their lives. They are promoted to carrying two bags at a time as young adults and men, and continue caddying into their 50s and 60s, when the profession begins to wear down their bodies until they are demoted to single bags, and ultimately can carry only putters for people who are riding in their carts. These caddies cannot afford to retire. They have no retirement benefits. They have not even made Social Security contributions.

These caddies also almost never report their income, and maybe that is their

own fault. I ask, however, whether society can really blame them when they are paid so minimally, while being given a false assurance that their clubs are taking care of them. These clubs may warn their caddies to report their income or pay their self-employment taxes, but such cautionary warnings may also come with a wink. While clubs would have this pending legislation give caddies more than a wink by officially classifying them as independent contractors, I implore this Committee to recognize the caddie-club relationship for what it really is in practice, and that is an employment relationship.

I believe that under any test of the employment relationship, whether it is the twenty factor test of the IRS Code or the broader test contemplated by H.R.1972 and H.R. 582, caddies will be considered employees. Exhibit 2. I understand, however, that many country clubs feel that because caddies have not been treated as employees for tax purposes for so many years, that clubs should be able to seek shelter from employer tax obligations under the section 530 Safe Harbor provisions. Even though most clubs do not file 1099 forms on behalf of their caddies, they argue that they should benefit from a tradition of relegating caddies to a worker classification that denies them an employment relationship.

The country club is always one of the last institutions in America to fall in line with common perceptions of equal treatment and social conscience. The clubs will not embrace such ideals because they believe such an embrace can come only at the expense of compromising tradition. While it may be tradition to deny caddies the benefit of an employment relationship, that does not make it right. The task with any legislation, is to test its boundaries. It extends section 530, H.R. 1972, and H.R. 582 beyond the boundaries of reason to permit employees such as caddies to be treated as independent contractors. If pending legislation can be interpreted to designate caddies as independent contractors, then it reaches too far and should either be tailored more narrowly, or not made law.

Thank you again for the opportunity to testify before you, and for trying to understand our position.

[Attachments are being held in the Committee Files.]

Statement of
Robert A. Georgine
President
Building and Construction Trades Department, AFL-CIO

Before the Ways and Means Oversight Subcommittee The Honorable Nancy Johnson, Chair United States House of Representatives

June 4, 1996

To the Honorable Nancy Johnson and Members of the Subcommittee:

I appreciate the opportunity to convey to the Committee the grave concerns of the Building and Construction Trades Department, AFL-CIO regarding H.R. 1972, as well as the Internal Revenue Service's inability to effectively combat rampant misclassification of workers occurring nationally in the construction industry.

The Department, which is a federation of 15 national and international building trades unions representing more than four million construction workers across the country, believes that H.R. 1972 and H.R. 582, as now written, would seriously and adversely affect the interests of the millions of men and women, and their families, who depend on the construction industry for their livelihoods. Moreover, the Department believes that recent IRS initiatives which limit potential tax liability for employers who misclassify their workers will only encourage continued abuse of the federal tax laws in the construction industry.

I. The Department's Concerns Are not With Legitimate Independent Contractors.

Let me make clear at the outset that the Department is not in any way challenging the right of workers to be their own bosses and build their own businesses. In the construction industry, it is a common occurrence for individual workers to make the transition from being employees to being contractors, and the Department does not want to do anything to harm their ability to do so.

What we are opposed to is the unscrupulous contractor who deliberately misclassifies workers and treats them as independent contractors even though the workers unquestionably are employees under any definition of that term.

This deliberate abuse of the tax laws costs the state and federal governments tens of billions of dollars of needed tax revenues, deprives workers and their families of pension and health benefits and other protections to which they are entitled, and creates an

unlevel playing field on which honest contractors who play by the rules are unable to compete. 1

II.

Flagrant Abuses are Occurring Every Day in the Construction Industry.

This is not some abstract tax issue. It is very real, and it is hurting real people. Every day, we see construction sites where there are scores, or even hundreds of workers, and yet every single worker is being treated as an independent contractor. The truth is, of course, that most if not all of these workers are employees. The reason they are being misclassified is not because the rules are too complex. The contractors know full well that the workers are employees, but they misclassify them anyway because they believe, with a lot of justification, that they will never be caught - and, even if they are caught, the penalties will be minimal.

Let me share with you just one recent example that has been called to my attention that demonstrates what is going on out there in the real world. This is a case that occurred in the last six weeks. We obtained affidavits from the workers involved, and those affidavits have been provided to the regional office of IRS.

In New York, a drywall contractor was awarded the contract on a public construction project. He hired seven drywall workers - who unbeknownst to him were union members - to do the drywall work under his supervision. The terms of their engagement made it clear that they were employees.

Even though the workers clearly were employees, the contractor told them they would be issued 1099s rather than W-2s. The job they were hired to do was subject to the state's prevailing wage law, which required the drywall contractor to pay certain wages to all employees, but the workers were not being paid the required amounts.

The New York State Department of Labor performed a surprise inspection of the job site. When the state inspector revealed his identity, the contractor told the workers to "disappear" until the inspector left the site. The following evening, the contractor telephoned one of the workers and offered him \$5,000 if he would falsely claim that the other workers were his employees and not the employees of the company. In this way, the drywall contractor hoped to buy his way out of trouble.

Substantial uncollected taxes and penalties are due from this contractor. It is clear that the contractor knew the workers were employees, since he

¹ By misclassifying their workers, construction contractors can save 30% to 40% of their labor costs, by virtue of the fact that they illegally avoid paying social security, medicare and unemployment taxes, as well as worker compensation premiums. The contractors also thereby avoid providing pension and health coverage to the workers and their families. Such illegal cost savings give the unscrupulous contractors enormous bidding advantages over legitimate contractors.

told them to "disappear" from the job site as soon as the labor inspector showed up and then offered one of the workers \$5,000 to falsely claim the other workers as his employees.

And yet, when the workers went to the local IRS office and presented these facts and supporting affidavits, they were told that nothing would be done because these types of cases are considered a low priority. I should point out in defense of the IRS that these cases are considered low priority because this Congress last year removed all enforcement funding for the agency. There is no one available to follow up on situations like these. These incidents I have just described are, when compared to other concerns faced by IRS, of lessor priority. Yet, the failure to be able to act against violators of public law simple encourage employers to continue to violate the law.

Here we have substantial revenues that are owing and could be collected, the IRS is presented with a strong, ready-made factual case supported with affidavits - and the IRS does nothing. I would hope that Congress would immediately take steps to remedy this situation and ensure that the laws are being enforced.

H.R. 1972 and H.R. 582 Would Protect Construction Contractors Who are Abusing the Tax System.

Instead of providing for greater enforcement, however, Congress is considering legislation like H.R. 1972 (the "Christensen bill") and H.R. 582 (the "Kim bill"), which, if enacted, would protect employers like the drywall contractor described above as long as they had the foresight to compel their workers to sign written contracts containing certain representations.

The Christensen bill and Kim bill set out a number of factors to be applied in order to determine whether a worker is an employee. However, these factors are contained in a series of <u>alternative</u> criteria so that a worker's satisfaction of only a minimum number of factors would result in classification as an independent contractor.

Under the Christensen bill, an employer may treat a worker as an independent contractor by making the following three showings:

- in the year of the services or in the immediately preceding or subsequent year, the worker has performed a significant amount of services for other persons;
- 2) the services are performed by the worker pursuant to a written contract which provides that the worker will not be treated as an employee with respect to such services; and
- the worker is treated as having a significant investment in assets and/or training.

The first requirement under H.R. 1972, regarding work for others, typically will be met in the case of construction workers who are employees, since they

often work for a number of contractors over a three-year period. Thus, this requirement provides no meaningful basis for distinguishing employees from true independent contractors in the construction industry. Moreover, the written contract requirement easily could be satisfied by a contractor that wants to treat its workers as independent contractors, even though those workers are in every real sense employees. Finally, a construction worker who owns more than the most minimal hand tools could be considered to satisfy the third requirement, and thus would be treated as an independent contractor under the Christensen bill.

The Kim bill also protects contractors and allows employers to treat workers as independent contractors even though they clearly are employees. It provides that an individual is not treated as an employee if:

- the worker has a separate principal place of business and has a significant investment in tools; and
- there is an agreement between the service-recipient and the worker which contains certain representations about the engagement.

These requirements could be satisfied in the case of construction workers who are in every real sense employees, since such workers often have "home offices" where they keep records and take calls, and they typically own their own tools. The written agreement requirement obviously would not pose a problem for construction contractors who wish to misclassify their workers.

The fundamental problem with H.R. 1972 and H.R. 582 is that both bills presuppose that employers are acting in good faith and that the only reason for noncompliance is the complexity of the rules. While that may be a reasonable assumption in some industries, it very definitely is not the case in the construction industry, where the patterns of deliberate abuse are well-established. Construction workers are particularly vulnerable to veiled threats by contractors that unless they agree to sign on as independent contractors, they will not be hired.

The Department's concern is that H.R. 1972 and H.R. 582, as now drafted, would permit a worker to be treated as an independent contractor based on the satisfaction of only a minimal number of factors. Such an approach is simply not appropriate in the construction industry, given the economic incentives for misclassification and the history of abuses by many contractors. H.R. 1972 and H.R. 582, in my view, would serve only to encourage contractors to manipulate classification rules to the detriment of the worker.

If it is determined that the approach now embodied in H.R. 1972 or H.R. 582 meets the needs of other industries, the Department urges that at a minimum the bills be amended expressly to recognize the special circumstances of the construction industry by either (a) specifically excluding the construction industry from their coverage, or (b) including special rules that would govern the classification of workers in the construction industry.

IV.
The IRS's Recently Announced
Classification Settlement Program
Exacerbates Serious Abuses
in the Construction Industry.

On March 5, 1996, the IRS announced its Classification Settlement Program ("CSP") which drastically reduces the deterrent value of audits by allowing employers who misclassify workers to pay only a small fraction of the taxes they owe.

Under the CSP, a construction contractor that misclassifies its workers will be required to pay only the amount it owes for one year. This is opposed to the amount it could owe for the two or three years open under the statute of limitations. All companies may take advantage of this, as long as the contractor consistently filed Form 1099s for its workers.

Moreover, a construction contractor will receive an even bigger break under the CSP if it consistently filed Form 1099s and has merely a "colorable" legal argument that it meets the other requirements for section 530 relief.²

These substantial tax breaks are available under the CSP even though the employer clearly has misclassified employees. The CSP is "tax forgiveness" on a massive scale, and it considerably reduces the tax risks for employers who misclassify their workers. The CSP will only encourage contractors -- like the drywall contractor in New York described above -- to continue ignoring the worker classification rules.

We urge the Committee to review the CSP to confirm that it is undermining compliance with the tax laws and to take steps to cause IRS to reconsider this recent, ill-conceived program.

The Department will be pleased to provide you with any further information or to meet with you or your staff at your convenience. Again, let me express the Department's appreciation for the opportunity to convey these concerns regarding this very serious issue.

² Section 530 provides that a worker found to be an employee under the common law test will be deemed to be an independent contractor for employment tax purposes if certain conditions are met. These conditions are: 1) that the employer did not treat the worker as an employee during any prior period, 2) since 1979 the employer has filed applicable information returns, i.g., Form 1099, on a basis consistent with independent contractor status, 3) the employer has classified the worker in the same way it classified all other workers holding substantially similar positions since 1978, and 4) the employer had a "reasonable basis" for classifying the worker as an independent contractor. Pub. L. No. 95-600, § 530, as amended by Pub. L. Nos. 96-157, 97-248 and 99-514.

Computer Software Industry Association

Committee On Ways and Means Hearing of June 4, 1996 on Employment Classification Issues

Statement for the Committee Record by the Computer Software Industry Association

June 17, 1996

This testimony is submitted for consideration by the committee and for inclusion in the printed record of the June 4th hearing of the Oversight Subcommittee of the House Ways and Means Committee.

The Computer Software Industry Association (CSIA) membership consists of over 3,000 companies in the computer software industry both within California and across the United States. Our members have been extremely negatively affected by worker classification problems.

Computer Software Industry Is Singled Out For Harsh Treatment

Many of our members are small businesses which provide software and electronic product development services to larger companies. CSIA is sure that you are aware of the problems caused for all businesses by worker classification problems. In our industry these problems are even worse due to the extremely discriminatory Section 1706 provision of the 1986 Tax Reform Act which enacted Section 530(d). That provision, for no valid reason, singles out the high tech industries for especially harsh treatment in worker classification audits. Prior to 1986 there existed a very efficient network of computer consultants and brokers who were able to offer services to a variety of clients. This network has now broken down, forcing many consultants, who wish to remain self-employed, to turn down work formerly available on a contract basis which is now offered only on an employee basis. Further market inefficiencies exist in the inability of companies to obtain the skilled technical expertise needed since company policy now frequently prohibits use of independent contractors at all, due to the fear of unreasonable IRS audits. The most skilled technical experts typically refuse to accept work requiring them to become short-term employees. This is due to their existing investment in equipment and other business assets, as well as their ability to provide consistency in their own self-provided retirement and health care benefits.

Board Members

President: Kaye Caldwell
President, Caldwell Software Solutions
Software Forum Representative

President, Shireman Software ICCA Representative

Treasurer: Alan Miller President, Deltam Systems, Inc. NACCB Representative

> Secretary: Terry Ramus Principle, Analytical Chemist Diable Analytical, Inc. PATCA Representative

CSIA 101 First St.,Suite 324 Los Altos, CA 94022 (415) 948-9192 There are further negative effects on the computer software industry which result from worker classification problems.

CSIA believes that one effect of worker classification problems is that they serve as a major driving force behind the industry's heavy use of foreign labor for product development and other short term (1-3 year) projects. It is indeed unfortunate that our own government prevents U.S. companies from doing business with U.S. experts while at the same time providing immigration programs such as the H1-B which encourage companies to import expertise from overseas. The IRS' policy of restricting access to U.S. experts works hand in hand with the immigration policy of encouraging short term importation of foreign experts resulting in the efficient transfer of U.S. know-how to foreign countries. This lessens our own country's long term global competitiveness.

Another effect is to deprive our technical experts of their intellectual property rights and to hinder the spread of useful technologies to the public. An independent contractor retains ownership of the copyright in his work. Portions of the copyrighted work can be assigned to a client, as appropriate, for a particular project. Other portions can be retained by the contractor for re-use in other projects for other clients. However, when the expert is forced to work as an employee all copyrightable work becomes the property of the employer - thus preventing the contractor from reusing it. This again negatively impacts the global competitiveness of the U.S. software industry.

Coupled with other discriminatory treatment of the software industry in additional tax areas it certainly seems as though our government is extremely interested in seeing that the software industry moves overseas as quickly as possible.

Revenue Impacts of H.R. 1972

We are aware that it is claimed that there will be a revenue loss due to the passage of H.R. 1972. We fail to see the justification for this claim. Government reports have concluded that misclassification of employees as independent contractors increases tax revenues due to the tax-favored status of many employee fringe benefits. Independent contractors pay more taxes due to the fact that certain benefits granted to employees are not available to independent contractors. The current partial deductibility of health insurance is but one example. The claim that independent contractors can deduct certain business expenses, typically office expenses, which cannot be deducted by an employee is highly misleading. In the case of an employee those expenses are typically paid by the employer and are deductible by the employer. As for the claim that some taxpayers will fail to pay taxes at all or will underreport their taxes, please note that the benefits of the "safe harbor" definitions of H.R. 1972 do not apply if 1099 reports are not filed. Also note that government studies have shown that, with 1099 reporting, tax compliance is very high. The current system of harsh and overbroadly applied employment audits punishes all businesses for the sake of preventing tax non-compliance by a few. This is highly inappropriate.

It Is Time To Resolve These Problems By Passage Of H.R. 1972

Worker classification problems have consistently been a serious problem for businesses. Severe penalties can be imposed even when both the service recipient and the service provider have filed all required forms and paid all required taxes. This situation should not be allowed to continue. H.R. 1972 offers a solution to this problem by defining when a worker is not an employee. We urge Congress to pass this legislation.

Kaye K. Caldwell

Kaye K. Caldwell



CONSTRUCTION
FINANCIAL
MANAGEMENT

THE VOICE OF CONSTRUCTION FINANCIAL MANAGEMENT

TESTIMONY OF

THE CONSTRUCTION FINANCIAL MANAGEMENT ASSOCIATION

REGARDING WORKER CLASSIFICATION ISSUES

BEFORE

THE HOUSE WAYS AND MEANS SUBCOMMITTEE ON OVERSIGHT

JULY 8, 1996

[written testimony submitted for the record]

Ms. Chairwoman and Members of the Subcommittee:

The Construction Financial Management Association (CFMA) is pleased to comment on the various proposals designed to address worker classification issues that have been proposed by Congress and the Administration. Classification of workers as either employees or independent contractors has been a perennial problem for all parties involved in this issue and CFMA supports efforts to clarify and simplify the myriad of rules, factors and circumstances that dictate current law.

CFMA was established in 1981 and represents more than 5,800 financial managers in the construction business. Our members are employed by over 2,500 construction companies across the U.S. More than one-third of these members have gross annual revenues ranging from \$25-99 million.

We commend Chairwoman Johnson and the Subcommittee for its leadership in examining the worker classification dilemma, and we appreciate the opportunity to comment on behalf of CFMA and its members. Legislative activity in the worker classification area has recently gained momentum with the inclusion of several modifications to Section 530 in the Senate version of H.R. 3448, the Small Business Job Protection Act of 1996, and with new proposals by Treasury that were first announced at a recent Subcommittee hearing.

We know the Subcommittee will scrutinize every proposal very carefully and we encourage the Members to consider the economic contribution and unique requirements of the construction industry when deciding what approach is best for resolving this long-standing worker classification problem.

SENATE MODIFICATIONS TO SECTION 530

The Senate has proposed several clarifications and modifications to section 530 as part of its amendment to H.R. 3448, the *Small Business Job Protection Act of 1996*. CFMA supports the Senate's attempt to set clearer standards for taxpayers and the IRS to follow under section 530.

Industry Practice Safe Harbor: CFMA supports the Senate proposals to modify the industry practice safe harbor. The Senate amendment to H.R. 3448 would recognize that at least 25 percent industry participation in the same business segment is sufficient for the taxpayer to show a reasonable basis for treating a worker as an independent contractor. CFMA also favors the proposed modification to the IRS' interpretations so that an industry practice can be long-standing if it has been in place for at least 10 years. An industry practice in existence for a shorter period of time may be considered long-standing based on the facts and circumstances of the industry.

Shift Burden of Proof: CFMA also appreciates the Senate's proposal to shift some of the burden of proof in section 530 cases from the taxpayer to the IRS once a taxpayer establishes a prima facie case. The legislative history of section 530 clearly states that the safe harbor should be construed liberally in the taxpayer's favor. Shifting the burden of proof to the IRS in cases where a taxpayer has a reasonable basis for treating workers as independent contractors and has complied with IRS requests for information should help prevent needless and costly litigation.

<u>Prior Audit Safe Harbor</u>: We are concerned, however, that the provision to eliminate the prior audit safe harbor for non-employment tax audits commencing after December 31, 1996, would have an adverse effect on new entrants to the construction industry.

CFMA OPPOSED TO GIVING TREASURY AUTHORITY TO ISSUE GUIDANCE

One of the new worker classification proposals by Treasury at the recent Subcommittee hearing would provide Treasury with the authority to issue "a revenue ruling or other guidance," in order to "improve understanding of the common-law classification standard and its application in different industries."

CFMA supports the goal of simplifying this complex area and we agree that some factors are more important in a particular industry than others. However, we believe it would be a serious error to give Treasury sweeping authority to influence the IRS examination policy and position on who is and who is not an employee on an industry-wide basis, thereby reversing the prohibition on regulatory action originally and intentionally imposed by Congress on Treasury and the IRS. The goal of section 530 and the freeze on regulatory action was to require determinations to be made on a case-by-case basis, not on a wholesale basis.

Congress has had sole authority to govern the classification of workers since 1978 because of the controversies that developed between the business community and the IRS over the independent contractor issue. If Treasury is given authority to propose new guidance through regulations or rule-making authority, it would constitute a major shift in power from Congress to Treasury and the IRS and would represent a dramatic change in congressional policy on the worker classification issue.

CFMA believes that other proposals by Treasury do merit consideration by the Subcommittee, although additional details on the provisions would have to be reviewed by CFMA before we could support them. Proposals to allow employers to eliminate all prior employment tax liability in certain instances where workers were misclassified and expanded Tax Court jurisdiction to resolve disputes more quickly and less costly than in Federal district court could prove to be valuable tools to the construction industry.

BACKGROUND ON SECTION 530

Congress adopted section 530 of the Revenue Act of 1978 in recognition that the rules on the classification of workers as "employees" or "independent contractors" were imprecise. For years before section 530 was enacted, the IRS increased its employment tax audits -- leading to increased controversies between the IRS and businesses. Section 530 was a stopgap measure to provide Congress time to produce a permanent solution to the complexity of the

Statement of Treasury Acting Assistant Secretary Donald Lubick, before the House Ways and Means Oversight Subcommittee, page 10, June 20, 1996.

independent contractor issue that would eliminate this source of controversy. While Congress has made some progress on the issue, it has also learned the lesson learned earlier by business and the IRS: this issue eludes simple solutions.

Congress addressed this issue in 1982. Statutory standards were adopted for two types of workers (direct sellers and real estate agents); if the standards are met, the workers will be treated as independent contractors. Congress also decided, as part of the same 1982 legislation, to extend section 530 relief to all other types of workers. Clearly, the Congressional intent was to simplify and clarify the law where possible, in this case for direct sellers and real estate agents, and to leave everyone else as is. Consequently, section 530 was indefinitely extended to give Congress time to produce legislation on the classification of workers as independent contractors or employees without reigniting controversy with the IRS over the classification issue. Congressional actions in 1978 and 1982 clearly indicate that section 530 was intended to help taxpayers.

IMPORTANCE OF SECTION 530 TO THE CONSTRUCTION INDUSTRY

Each construction project involves an amalgamation of independent economic entities that come together under unique and complex legal arrangements for a specific job and then disperse. These entities are a combination of corporations, partnerships and sole proprietors who associate as general contractors, subcontractors, first-tier subcontractors and second tier subcontractors, and suppliers and vendors.

Within the construction industry, the general-subcontractor and subcontractor-subcontractor relationships have always been the norm for doing business. Additionally, specialty trade contractors are hired on a project-by-project basis for short durations under varying contractual arrangements to complete certain assignments. Some of these contracts can include lump-sum, fixed-fee, cost-plus, time and material, or labor-only agreements. Contractors can be selected on a competitive bid or negotiated basis depending upon the assignment.

The construction industry has always relied upon the existence of a contractor-subcontractor relationship to carry out construction jobs. The industry must continue to rely on these relationships because:

- the requirements of each particular project differ so dramatically as to the scope of work to be performed, the degree of skills needed, the number of disciplines to be engaged, and the human resources to be allocated;
- general contractors cannot afford to hire the number and variety of trade specialists they need as full-time or even part-time employees; and
- construction work, by its very nature, is cyclical, unpredictable, intermittent and non-repetitive.

To remove the section 530 "safe harbor" would threaten the long-standing industry practice of subcontracting and would threaten the ordinary way of doing business for smaller contractors and, especially, sole proprietors.

If section 530 is not available for the construction industry, the IRS could attempt to recharacterize legitimate independent contractors as employees, producing uncertainty and confusion for the industry. To avoid such a result, industry practice would have to be changed. And, before those practices can be changed, many general contractors will find that -- in the eyes of the IRS -- they are not general contractors but employers.

For example, in construction management, it is long-standing industry practice for an owner to contract directly with a general contractor who will manage a project and enter into contracts with trade specialists and other independent contractors. However, it is also common industry practice for an owner to contract directly with a general contractor and with trade specialists and other independent contractors. In both cases, under industry practice, the general contractors and the subcontractors are independent contractors.

If section 530 protection were removed, however, it is all but certain that some IRS agents will decide that owners who contract directly with subcontractors are employers under the common law 20 factor test. Consequently, owners, general contractors, and subcontractors will be left in a situation where they can no longer feel confident when they have issued a contract or work order that the IRS will view the arrangement similarly.

In addition, it is important to note that most construction contracts are acquired on a competitive bid basis. By removing section 530 protection, contractors would have to either increase the price for this contingency or else assume that any changes would impact their bid profit. This situation simply adds risk to an already very risk-laden business. (For additional information on the importance of section 530, see Appendix).

Several examples of subcontractor situations that could be misconstrued by IRS agents as employer-employee relationships are:

- · punch list clean-up where many miscellaneous corrections are required in the work;
- contracts which only involve installation with materials supplied separately, e.g. HVAC subcontractor to install a central air conditioning system; and
- remodeling work where hidden site conditions are unknown and, therefore, the extent of the work is not determined in advance.

Given the competitiveness of this industry, it is important to retain section 530 in order to have a consistent approach to worker classification issues and not agent-by-agent determinations.

CONCLUSION

CFMA contends that the majority of construction contractors use legitimate independent contractors for legitimate economic reasons. CFMA also recognizes that there are abuses in the system, but does not believe that these abuses are so widespread that the entire working structure of the industry needs to be dismantled.

CFMA supports the Senate proposals to modify the industry practice safe harbor and to shift some of the burden of proof in section 530 cases from the taxpayer to the IRS once a taxpayer establishes a prima facie case. We believe, however, that the Senate's proposal to eliminate the prior audit safe harbor for non-employment tax audits commencing after December 31, 1996, would have an adverse affect on new entrants to the construction industry.

CFMA believes that certain proposals by Treasury merit consideration, particularly those proposals that would allow employers to eliminate all prior employment tax liability in certain instances where workers were misclassified and would provide expanded Tax Court jurisdiction to resolve disputes more quickly. CFMA remains concerned, however, with the proposal to provide Treasury with the authority to issue a revenue ruling or other guidance. While providing guidance in this area may sound appealing, Treasury's goal of increasing tax revenue undermines this approach and could result in more controversy. To allow Treasury to have such sweeping authority to influence the IRS examination policy, thereby reversing the prohibition on regulatory action originally imposed by Congress on Treasury and the IRS could have detrimental effects on the construction industry.

APPENDIX

LIFE WITHOUT SECTION 530

We thought it might be helpful for the Subcommittee to see how these 20 factors -- in the absence of the Section 530 safe harbor -- might be used to recharacterize a traditional contractor relationship as an employer-employee relationship. Not all of the 20 factors have to be met to find the employer-employee relationship, so contractors will be faced with the possibility of having to continually defend how they do business with subcontractors.

Examples of how the 20 factors could be interpreted by IRS to question the existence of subcontractor relationships and to find an employer-employee relationship are as follows:

- Instructions: The general contractor has the overall responsibility for safety and management of the job site and will direct subcontractors when they can work and the safety rules to be followed on the project.
- 2. Training: Certain work may be very technical or complicated, which could result in the general contractor providing training for subcontractor workers regarding materials handling, installation, safety, etc. For example, in the construction of "clean rooms" for manufacturing wafers and computer chips, it is common industry practice for the general contractor to provide "cleanliness training" for all workers -- including the subcontractors' workers -- to insure that the "clean rooms" meet contract requirements.
- Integration: The general contractor will provide the schedule of access and completion
 times and coordinate work of other specialty contractors to minimize interference and
 increase productivity.
- Service Performed Personally: A subcontractor's principal may also perform a portion of the work, especially if it is a sole proprietor or a small contractor.
- Hiring, Supervising, and Paying Assistants: It would not be unusual to closely supervise
 and direct workers of a subcontractor who are in the process of correcting punch list
 items
- Continuing Relationship: A pattern of repeat business with the same general contractor could be read as a continuing employer-employee relationship.
- Set Hours of Work: The general contractor controls access to the project and, therefore, sets hours of work.
- Full Time Required: The general contractor monitors the progress of work and can force staffing changes to keep the work on schedule.
- Doing Work on Employer's Premises: By necessity, the work location is established and controlled by the general contractor since it must be done at the job.
- 10. Order or Sequence Set: The general contractor is responsible for scheduling and coordinating subcontractors and, therefore, sets the order of work to enable the project to be completed on time.
- 11. Oral or Written Reports: The general contractor requires regular reports from the subcontractors on the progress of the work in order to continually update the completion schedule and coordinate other trades.
- 12. Payment by Hour, Week, Month: Usually a contract is done on a lump-sum basis, but can be on a per unit, hourly or cost-plus basis. Anything other than lump sum could be suspected of representing an employee situation.

- 13. Payment of Business and Traveling Expenses: This is usually not a factor, but if it should be, it is possible that reimbursement of these expenses would be provided for in the agreement.
- 14. Furnished Tools and Materials: Most subcontractors supply their own tools, but it would not be unusual for the general contractor to supply materials purchased separately from the subcontract agreement.
- 15. Significant Investment: Many subcontractors can maintain a business with little investment by working out of their homes or minimal rented space and using rented tools and machinery.
- 16. Realization of Profit or Loss: Contractors will most likely have the exposure, but may have a cost-plus contract which could isolate them from most exposure to loss.
- 17. Working for More than One Firm at a Time: Small contractors may not have the capacity to do this, but will have multiple contracts to be done on a rotating basis.
- Making Service Available to the General Public: Subcontractors may be available to do work for general contractors, but not necessarily for the general public.
- 19. Right to Discharge: Owner contracts typically contain language that gives them the right to discharge any workers they find objectionable. The same right is given to the general contractor.
- Right to Terminate: A subcontractor under certain contracts can terminate a relationship, providing proper notice is given.

These examples show that there could be many situations which could be falsely read as employer-employee relationships, resulting in the assessment of inappropriate penalties, interest and taxes. The construction industry today does business as it always has -- by subcontracting work. This is the reason that long-standing industry practice is relied on by law and the courts, not only for the construction industry but for all industries.

WRITTEN TESTIMONY OF BARRY H. FRANK, ESQUIRE

AND JEFFREY COOPER, ESQUIRE

MESIROV GELMAN JAFFE CRAMER & JAMIESON

SUBMITTED TO

SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES
ON
INDEPENDENT CONTRACTORS

June 17, 1996

Madam Chairman and Members of the Subcommittee:

Barry H. Frank and Jeffrey Cooper are partners in the Philadelphia based law firm of Mesirov Gelman Jaffe Cramer & Jamieson. We have represented approximately one hundred businesses throughout the United States against the IRS attack on their use of independent contractors. We successfully represented Critical Care Registered Nursing, Inc., which was decided in favor of the taxpayer and have also settled favorably several cases in U. S. District Court prior to trial.

Most of the clients which we have represented are small businesses, that have been forced to defend themselves against the IRS challenge, at not only a heavy financial cost but also a heavy cost in terms of time. Sometimes I think it is the time needed by the business owner, which is taken away from their business in order to work with the attorneys to defend the IRS challenge, which can be as critical, if not more critical, than the financial cost.

Any legislation enacted by Congress must both include and clarify Section 530 of The Revenue Act of 1978. In addition, it is imperative that the legislative history, that Section 530 is to be liberally construed in favor of the taxpayer, be reinforced. Our experience is that the Internal Revenue Service ignores the directive that Section 530 be liberally construed in a majority of audits which it conducts.

Many of the businesses which we have represented, in more than thirty different industries, have sought protection under the third safe haven - (i) a long standing, (ii) recognized practice (iii) of a significant segment of the industry. The definition of "significant" must be clarified. Further, the application and applicability of industry surveys, whether local, regional or national, to establish industry practice, must be addressed.

Our attempt to define "significant" has, I am sure, met with the same obstacles as others. The Internal Revenue Service claims that significant should be eighty percent (80%) of an industry, yet, at the same time, acknowledging that the eighty percent may be too stringent; but has refused to lower that standard. On the

other hand, when the term significant is used in other sections of the Internal Revenue Code, whether it be related to the assessment of penalties, etc., its meaning has been found to be "less than fifty percent". Some objective range should be adopted and incorporated in any new legislation.

With regard to industry surveys, the Internal Revenue Service has repeatedly stated that an industry survey can only be used to satisfy the third safe haven, if it is a survey that was conducted or considered by the taxpayer at the time it started in business. We do not know of, nor have we ever heard of, any entrepreneur or business person that conducts a survey at or prior to the time they went into business. It is hard enough for someone to start a business without going out and paying for a survey.

In fact, many of the clients that we have represented in defending the IRS attack on their use of independent contractors had previously worked as an independent contractor themselves in that industry or a similar or related industry. The individual workers that they knew and came in contact with who worked in that industry also held themselves out as independent contractors. In other cases, we have represented businesses that, when first starting out, contacted workers and the workers themselves told the business owners that they only work as independent contractors. Also, if someone acquires an existing business that has always treated its workers as independent contractors, that should also have some impact.

We have represented businesses where professional surveys were conducted by the industry after the taxpayer began the business and at times contemporaneous with or close in time to the period under examination. When such surveys indicate that 70% or 80% or greater of an industry utilizes independent contractors, in all regions of the country, that survey is a definite verification that, in fact, the industry practice was and still is predominately staffed by independent contractors. If nothing else, such surveys should satisfy the fourth safe haven - any other reasonable basis.

The argument over whether Section 530 can and should be considered prior to considering the common law factors must also be addressed and, if Section 530 is found to apply, it must apply for all tax purposes, including pension plans, qualified plans, etc. For those taxpayers who are finally granted relief under Section 530, it is a total injustice that they still might be subject to attack because the Internal Revenue Service can claim that the workers are employees for other tax purposes.

The Independent Contractor Tax Fairness Act of 1985 (H.R. 582) is a step in the right direction but needs to be clarified and expanded in order to provide a fair treatment for all businesses and industries that traditionally use independent contractors. The Bill repeatedly uses the term "significant" in establishing the various tests to be used in meeting the three sets of requirements. Some dollar parameters along with some percentage of revenue generated by the independent contractor need to be established or nothing will be accomplished under the Bill, if adopted. The proposed legislation is well intended but as long as there are ambiguities and as long as the Internal Revenue Service is going to continue to aggressively attack businesses that properly and legitimately utilize independent contractors, the problem will not be solved. Something must be done to get the Internal Revenue Service to fairly treat companies that make a bona fide effort to use independent contractors.

There may be tens of thousands of businesses that pay their workers in cash and hundreds of thousands of workers who, being paid in cash. do not file tax returns or pay taxes; nor do we suggest that the workers and businesses be free from IRS enforcement. In fact, we encourage it. The cash economy should not taint those businesses and workers that legitimately engage in business by contracting with independent contractors. Despite the fact that the Internal Revenue Service, at the National Level, has taken steps which appear to be addressing the issue, the Classification Settlement Program makes it easy for the Internal Revenue Service to get companies to reclassify workers to employee status but, what about all of those businesses that want to, intend to, and need to continue to classify the workers as independent contractors. Their fight will have to continue because the Classification Settlement Program leaves an enormous gap between those companies will to convert their workers and those businesses that want to continue using independent contractors, unless they can clearly satisfy the IRS.

We appreciate the opportunity to submit this written testimony and to testify at any future hearings on the topic of independent contractors.

STATEMENT OF JOY J. TURNER OF JEFFERS BUSINESS SERVICES ON BEHALF OF THE DELEGATES TO THE WHITE HOUSE CONFERENCE ON SMALL BUSINESS

The Honorable Nancy L. Johnson, Chair Subcommittee on Oversight
Committee on Ways and Means
104th Congress of the United States
House of Representatives
1136 Longworth House Office Building
Washington, D. C. 20515

Madam Chair Johnson and Subcommittee Members,

The opportunity to provide my statement on the INDEPENDENT CONTRACTOR issue is indeed an honor and is sincerely appreciated. It is encouraging that this issue, so vital to the small business community, is receiving well-deserved attention and I am hopeful that it will receive positive action from your committee.

I have been empowered to speak on behalf of The National Association of Women Business Owners, The National Society of Public Accountants, The National Society of Tax Professionals, The National Minority Delegates Caucus, and my diverse clientele. My testimony comes from experience of several vantage points.

<u>First.</u> I am the owner of a small business, an accounting, tax and small business consulting company. I have operated this business on a part-time basis for more than fifteen years. I recently began a full time operation after having been an employee of a fortune top-ten company for twenty-six years. I hold two degrees in Accounting, have specialized certificates in tax and accounting subjects, earn 16-24 CPE credits each year, and have combined twenty years experience in Corporate Accounting, Federal Taxes (domestic and foreign) and Corporate Finance. I have no employees.

At some point in the future, I plan to have employees but for now, if and when I secure jobs that I cannot personally complete, I must use the services of an independent contractor. I market my accounting and business consulting services as an independent contractor. I have been adversely impacted by the twenty factors test as it now stands and is administered by the Internal Revenue Service. (Revenue Ruling 87-41 defines a twenty-factors control test based on common law principles.)

Just recently, I was put in the position of having to severe a contract before term. A non-profit organization's board of directors, acting out of fear that I may later be reclassified as an employee, insisted that I sign a legal document that went considerably beyond what was reasonable, practical or necessary for the scope of the job. It seems that several board members who happen to be attorneys became vaguely aware of the twenty-factors test. They reacted rather strongly and to my detriment. Since I did not want to become their employee nor did I want to sign my rights away in order to complete the contract, I requested mutual consent to end the relationship. A written document (contract) had already been executed which was quite competent to establish my position as an independent contractor. In accordance with current law, a reasonable basis existed for not treating me as an employee. We chose to end the relationship two months early. They suffered and so did I. I could not dispute that reclassifications would not lead to costly tax bills and I could not assure them that, upon audit, a reclassification would not occur, as the random determination would be up the discretion of an Internal Revenue Service agent.

Due to the nature of the work that I am educated, trained and skilled to perform, I am best able to provide my services to small business clients as an independent contractor. As an accountant or business consultant, I must maintain principles of independence of thought and action. The small business clients whom I service are small or micro businesses, start-ups or sometimes just people with flourishing ideas. They cannot afford to hire me as an employee nor do I want to give up the control and independence required to competently complete certain types of jobs.

For instance, in providing financial statements that accurately reflect the financial health of the client, I am not burdened by the compromises and conflicts that might beset an employee. In areas where conflict may arise, for example, are concepts such as asset valuations, inventory pricing or calculations of depreciation and expense or in the area forensic analysis where key employees may exercise extreme control over the results. The small business clients who need my services the most cannot afford the expense of administrative fees attached to payroll withholding requirements or the additional cost of payroll administration.

My <u>second</u> point of perspective comes from having served for the past ten years as a member of the IRS cadre of instructors who provide workshops and teach outreach sessions. I taught the SMALL BUSINESS TAX WORKSHOPS. A major segment of those workshops questions how to make the determination of who is an employee versus an independent contractor. The current law addresses the question "who is an employee?" rather than "who is an independent contractor?". This is a north-south focus on the issue, when what is required is a reverse point of view. In other words, let's first clearly determine who is an independent contractor, then anyone else must be an employee.

At the present time, IRS audits seem to favor reclassification to employee rather than to independent contractor. This is usually a false economical decision. The fines and penalties are (false) revenue producers but have not led to increased compliance.

My third point of view comes from the many months of hard work involved with the White House Conference on Small Business. I served as Co-Chair of the New Jersey Tax Committee. Many small business people were interviewed and the independent contractor issue was discussed at length. Evidential cases were submitted. Small business people shared many horror stories of what had happened to them or other owners during audits and reclassifications. Some were nearly put out of business as a result of the assessment of fines and penalties due to incorrect classifications even though fraudulent intent was not present.

At the National White House Conference on Small Business, the one conference issue to receive the most votes of air sixty was the Issue of redefining an independent contractor (over 1400 votes). Although I had personally promoted this issue on behalf of the National Association of Women Business Owners, the votes projected the voice of small business.

My fourth point of view, comes from the recognition that this issue, not only received the most votes of the White House Conference on Small Business, but was also the top tax issue of over four hundred delegates who comprised the Minority Delegates Caucus (MDC). I served as the Tax Issues Director of the Minority Delegates Caucus. Of all small business owners who are independent contractors or who use independent contractors most, a high percentage is minority and women owned businesses. A large number of displaced and downsized corporate employees became independent contractors, a disproportionate number are women and minorities. This, one might say, was also due to economical reasons.

Another and <u>fifth</u> perspective has been brought about by my involvement in such organizations as the National Society of Public Accountants (NSPA) where I serve on the National Affairs Committee and the National Association of Tax Professionals (NSPT) where I serve on the state planning committee. These organizations include many small business owners who are entrepreneurs, sole proprietors, S-corporations and Limited Liability Corporations. They cannot always afford to put an expert on the payroll. For complex business problems, a solution may be sought from an independent contractor; whereas, a large corporation can afford a resident specialist on payroll. Due to the cyclical nature of the strictly tax oriented business, employees may not be needed long enough to justify the cost of setting up payroll withholding procedures.

During the past year, there has been infinite discussion of the issue of clarifying who are independent contractors and determining who are employees. Congressman Jon Christensen and others co-sponsored H. R. 1972, called The Independent Contractor Tax Simplification Act of 1995, which adequately sets forth a new criterion to be used in place of the twenty-factors test, but does not exclude it. Senator Kit Bond and Senator Don Nickles co-sponsored S.1610, Independent Contractor Tax Simplification Act of 1996, a mirror bill. Some of the major labor unions have had an adverse reaction to these bills for what they have perceived as attempts to make it easier for businesses to use the service of an independent contractor rather than employ the traditional employee. There seems to be fear of the wholesale conversion of many employees to independent contractor status, with or without their concurrence. This is a valid argument. One which has caused several congress people to become timid on the issue, but backing up and out does not make the need for action disappear.

Having been a labor union delegate in the early stages of my career, I helped to make such arguments. My very first experience with independent contractors occurred while employed by a major corporation where independent contractors shared space with employees. They worked alongside the employees, did the same jobs and received higher pay but no benefits. This was unsettling for the union and the employees. Having had this experience firmly convinces me, that it would be beneficial to the labor union's work force as well as to small business if there were a clearer definition of what determines who is an independent contractor and better ways to distinguish them from the employees. There has to be a better way and we have to work together to get to it. Right now, corporations so easily get through the loopholes using the current common law structure. This demands tightening up with better criteria. A clearer definition should be in place so that when a worker enters the door, all parties would know immediately whether this is an independent contractor arrangement or if this is an employee/employer relationship. A genuine non-partisan effort is required by ALL of congress to help strengthen and close the existing loopholes by developing a more definitive law.

Commissioner Margaret Richardson, Deputy Commissioner Mike Dolan, Director Barbara Jenkins and others at the Internal Revenue Service have done a heroic job at the administrative level to help resolve this issue. I will not reiterate all that they have done for it is in the public record. It was quite commendable that the draft of the new training manual was made available to the WHCSB Tax Chairs for input and suggestions. Although it is more than one hundred pages, I am pleased to have had the opportunity to contribute to the document for future training. It is now time for congress to sincerely "come to the table with good intentions" to resolve this issue.

Independent contractors are essential to the successful operation of a variety of business and industry types. While it is a fact that this issue is of great importance to the small business world, it is also important to large business and corporations. Independent contractors offer specialized skills for short term projects yet it should not be as easy as it currently is to replace traditional employees with independent contractors. Also, it should not be difficult or impossible for independent contractors to secure contracts without the fear of future reclassification.

All of the small business community is concerned with unreported income resulting from failure to file Forms 1099. These omissions translate into a tax increase to the rest of us who attempt to comply with the law. Voluntary compliance can best be promoted by clear unencumbered laws, education, reduced complexity of reporting and a more friendly environment from the local IRS personnel. It should be noted that the IRS has in recent years made commendable efforts to improve its client service atmosphere.

Statistics indicate that this country is being run by small and micro businesses. Small businesses employ about 54 percent of the private work force and contribute 52 percent of all sales in the country. What is required is to make it easier for them to comply with the income tax laws rather than to make it more difficult. During the 1976-1990 period, small firms with fewer than 500 employees provided 65 percent of net new jobs. This percentage does not appear to be in danger of slipping and is not being threatened by the use of independent contractors. Recently, small business dominated industries increased employment by 1.3 million workers, a 3.2 percent increase.

In conclusion, it is common consensus that a better definition of the independent contractor is urgently needed. In the process of getting there, we do not want to make it more difficult for the small business person to run a profitable, viable business. The proposed solutions as addressed by H. R. 1972 and S. 1610, should be considered as a first step, a beginning point.

If our system is to remain one of voluntary compliance, withholding should not be considered. The additional burdens of requiring withholding taxes from independent contractors would only encourage the development of creative ways to avoid the problem. It would serve to punish those small businesses who jump through the hoops of compliance.

Safe Harbor provisions are absolutely necessary. If a small business owner has made a good faith attempt to classify a worker under current common law..., and the independent contractor had filed appropriate information returns, reported income and paid tax, then as a result of audit, penalties should not be assessed.

Control and supervision should be primary factors of any criteria. Safeguards that prohibit abuse of the system and provide protection of the workers are critical requirements. Workers should not be classified as independent contractors when there are no elements in the relationship to warrant it, and an independent contractor classification should never be allowed as a unilateral option. Those workers who want to be independent contractors, should be allowed to legitimately be classified as such without the insecurity of future reclassifications. There must be measures at the beginning of the relationship to determine who owns the tax liability.

I look forward to working with your committee to find an agreeable solution to the pressing issue of Independent Contractor Classification. I thank you and your committee for your consideration of this matter.

Respectfully submitted,

Tumer

Tax Chair-WHCSB Region II

New York, New Jersey, Puerto Rico

Statement of the Direct Selling Association Concerning Independent Contractor Status Before the Subcommittee on Oversight of the Committee on Ways and Means U.S. House of Representatives

The Direct Selling Association (DSA) appreciates the opportunity to submit this statement in connection with the committee's hearings on independent contractors on June 20, 1996. DSA is the national trade association of the direct selling industry. We represent over seven million independent contractor direct salespeople and the 180 direct selling companies for whom they market goods and services. We have, during the course of a year, on average over 16,500 direct salespeople per Congressional District and are presently recruiting over 62,000 distributors and salespersons per week. Our members firms account for over 95% of industry sales, and while many are large and familiar household names, a majority of them are small businesses.

Background: The Independent Contractor Status of Direct Sellers Is Well-Established for Federal Tax Purposes

The independent contractor status of direct sellers has long been recognized for federal tax purposes. Almost 20 years ago, in a test case, direct sellers were found to be independent contractors for tax purposes under the common law rules (Aparacor, Inc. v. United States, 556 F. 2d 1004 (Ct. Cl. 1977)). In 1982, Congress adopted I.R.C. § 3508 to "provide a statutory scheme for assuring the status of ... direct sellers and real estate salespersons as independent contractors." (Staff of the Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982 (1982), 382).

Internal Revenue Code Section 3508 establishes three conditions in order for a person to qualify as a "direct seller" treated as an independent contractor by statute. First, the person must be engaged in the business of selling consumer products to any buyer on a buy-sell, deposit-commission, or similar basis, in the home or otherwise than a permanent retail establishment. Second, substantially all of the remuneration paid must be directly related to sales or output, rather than to the number of hours worked. Third, the direct selling must be performed pursuant to a written contract between the direct salesperson and the direct selling company, and the contract must provide that the direct salesperson will not be treated as an employee of the company for federal tax purposes.

As part of this statutory classification of direct sellers as independent contractors for tax purposes, Congress also adopted a special tax information reporting requirement for direct salespersons. See I.R.C. § 604 1A(b). Under this special direct seller information reporting system, each direct selling company that sells \$5,000 or more of consumer products to a direct salesperson must indicate so on a special direct seller box on the IRS Form 1099-MISC, which is then filed with the Internal Revenue Service and sent to the direct salesperson. This information filing requirement also applies to a distributor in a multi-level direct selling arrangement who is wholesaling to direct salespeople in his or her sales organization. In addition, the Form 1099-MISC is used to report the payment of commissions, bonuses, and awards to direct salespeople in excess of \$600. The direct salesperson is required to provide his or her proper taxpayer identification number to the direct selling company as part of this process.

This statutory treatment of direct sellers as independent contractors and the special direct seller tax information reporting procedure constitute a clear and well-established system that has worked effectively for federal tax purposes for more than a decade and has achieved an extremely high rate of voluntary tax compliance for the direct selling industry. In discussions regarding independent contractor issues raised by recent health care reform efforts, senior representatives of the Treasury Department and the Internal Revenue

Service ("IRS" or "the Service") confirmed that the current statutory arrangement for direct sellers under Internal Revenue Section 3508 is working well and has produced a good compliance record. Our latest compliance estimates run in the 97% range.

Independent Contractor Status Generally

DSA believes it important to the nation that legitimate use of independent contractors, by all industries, not be threatened. The IRS has exhibited in the past and reportedly continues today to exhibit antipathy towards independent contractors and self-employed individuals. This antipathy is, in all probability, based on the belief that tax compliance levels for these groups are too low relative to compliance by employee groups. From an enforcement point of view, Section 530 of the Revenue Act of 1978 was originally enacted by Congress (and then indefinitely extended in 1982) as a direct result of IRS harassment of independent contractors and misclassifications by the Service of independent contractors into employee status. This harassment was done through abuse or misinterpretation by the Service of the twenty factor common law test of independent contractor status.

Finally, based on our own studies, people want to be independent contractors because they like being their own bosses, working their own hours, building their own businesses and directly relating effort to reward. Tax considerations generally do not enter the picture for them. From the viewpoint of the users of independent contractors, while there are some tax benefits created by this status, there are also productivity, recruiting, retention and tax disincentives as well. Businesses and individuals should be able to choose within structures they wish to operate.

Direct Sellers Would be Unnecessarily Harmed by Withholding

Over the years and recently, the General Accounting Office and the IRS have advocated withholding on independent contractors. Withholding would be counterproductive and an unnecessary burden to the direct selling industry. As this statement will show, it would do significant harm to the companies relying on the independent contractors and the independent contractors themselves. Withholding would ultimately result in the loss of approximately 10% of these independent contractors to our industry.

Over 80% of direct sellers (approximately 5.7 million individuals) earn less than \$2,500 per year. Our turnover rate is approximately 100% per year. Four percent of the adult population presently sell for our companies. An additional 13% have done so in the past. The difficulty of withholding on such a large number of people, who earn such small amounts of money, would hardly be worth the administrative costs and burden to both the private sector and the government. Studies conducted by our outside economic consultants indicate that the deductible costs of such a withholding system would largely offset the *de minimis* amounts of revenue collected. Indeed, a study we conducted based on IRS data indicated a very low average uncollected tax liability (under \$9.00 per annum in 1982) per independent contractor direct salesperson.

Many direct sellers will have business expenses which will not be taken into account by withholding. Because most direct sellers' average gross earnings are so low, any withholding is likely to result in significant over-withholding. Thus, withholding will result in a burden on individual direct sellers that will likely remove some of the financial incentive for their involvement in the business--or at least make their entrepreneurial activities more difficult. Even should the over-withholding be returned subsequently, the direct seller's cash flow would be unnecessarily and unfairly limited by withholding as to make the enterprise less attractive. Also, an initially low collection rate could be the proverbial nose of the camel under the tent. This year's 5% rate could be next year's 25%.

Additionally, many direct sellers are compensated through a multilevel system of compensation. Bonuses, commissions and other payments are often "passed through" to other salespeople in the multilevel sales structure, i.e., a check to one top distributor is divided between that distributor and the other salespeople in his or her organization,

known as the "downline," perhaps numbering in the hundreds. These other salespeople then take their earnings and pass on a portion to people they have brought into the business who generated sales bonuses for this "upline" distributor. The complexity of computing, then imposing, a withholding requirement on these multiple levels of payments if obvious and potentially overwhelming.

Our studies also indicate that imposition of withholding could result in a substantial reduction in the direct salesforce. A change of status could eliminate up to two-thirds of direct selling income opportunities. Withholding is inimical to the micro-entrepreneurial nature of our salesforces. As stated previously, we estimate a loss of 10% of our salesforces, or 720,000 income opportunities, should withholding be instituted. Withholding is a step in the wrong direction, and it is not in our industry's or the national interest.

Conclusion

Industries seeking to protect the independent contractor status have traditionally received bipartisan support in Congress. Members of Congress have long understood the complexity of this "classification" issue and the need to protect this micro-entrepreneurial form of doing business. We are concerned, however, that any attempts to deal with the issues raised by this hearing might do inadvertent harm. Until now, Section 530 has proven to be the most inclusive, pro-independent contractor safe harbor test that Congress could enact. Any changes to this section of the law, whether they be designed to curb IRS abuses or to deal with the problem of misclassifications of employees in some industries resulting in competitive disadvantages for some firms, should be carefully handled. Inadvertent, unforeseen consequences harmful to industries legitimately using independent contractors must be carefully avoided. It is a very complex, economically significant area to both corporations and individual entrepreneurs. Experience has shown that there are many landmines in this area, and we urge that extreme caution be used in making any changes.

DSA appreciates the attention the subcommittee has devoted to this important and challenging issue. We trust that, as your deliberations continue, the legitimate use of independent contractors will be protected and preserved. We also respectfully urge that, in any changes in the law that might take place, nothing be done to endanger the statutory independent contractor status of direct sellers. By way of background, attached is a profile of the types of direct sellers in our industry.

Thank you for your consideration of our views. We are at your service to expand on this statement, to answer any questions you might have or to provide additional information.

Respectfully submitted,

Neil H. Offen, President Direct Selling Association 1666 K Street, N.W., #1010 Washington, DC 20006

Telephone: (202)293-5760 Fax: (202)463-4569

ltm Attachment

Addendum

Profile of the Typical Individual Direct Seller Small Business

Direct selling is a well established method for marketing products directly to consumers, primarily in their home, tracing its roots to colonial times. Companies within the industry market a broad range of consumer products and services, including household cleaning products, cosmetics and other personal care products, jewelry, cookware and other housewares, educational materials, household decorative products such as baskets, home improvement products, food, and vitamins.

Most direct selling companies within our industry are themselves small businesses. Over 99% of the individual direct salespeople that market these companies' products are independent contractors. Each of these independent contractors is, in effect a small business, most of them micro-entreprises.

Direct selling offers a broad opportunity for these individual entrepreneurs. There are virtually no barriers to entry into direct selling - precisely because of their status as independent contractors. It is a field open to anyone. There are no demands that direct salespeople make significant investments, put in a given number of hours per day or week, or adhere to any sort of set work schedule. Direct selling is an ideal way for people with an entrepreneurial spirit to earn extra money without experience, without capital, and without having to make a full-time commitment to an employer. It is also a wonderful career opportunity where the sky is truly the limit.

As the result of this ease of access and flexibility in work arrangements, direct selling has wide appeal among women who have significant family responsibilities, as well as substantial numbers of minorities, the elderly, and handicapped persons. Of our over 7 million independent contractor salespeople across the United States, 70.4% are women. Some 12.5% of direct salespeople are African-Americans, 4.7% are Hispanics, 1% are Asians, and .5% are Native Americans or Alaskan Natives. Approximately 4.5% are over age 65, and 8% have disabilities (three out of four of them with permanent disabilities).

The overwhelming majority of direct salespeople conduct their direct selling activities on a part-time basis. Eighty-nine percent of direct salespeople spend less than 30 hours per week at direct selling, and many do it only for a few weeks or months per year. Some 60% engage in direct selling for less than 10 hours per week. Based on our latest data, only 6% sell for 40 hours per week or more.

In the great bulk of cases, direct selling serves as a supplement to the family income, with the main household income source coming from outside the industry through the full-time employment of the direct seller, his or her spouse, or both. (Fifty-six percent of all direct sellers have traditional employment in addition to their self-employment as independent contractor direct salespeople. Eighty-six percent of direct sellers who are married have any employed spouse.) For 60% of salespeople, direct selling activities provide less than 10% of household income and for 72% of direct salespeople, direct selling produces less than 20% of family income.

Statement for the record in support of H.R. 1972

Ref: 6/4/96 Hearing of Subcommittee on Oversight of the House Committee on Ways and Means Hon. Nancy L. Johnson, Chair

Submitted by: Angelo C. Congello, Sr., C.E.O. in behalf of his company, ENCORE ENTERPRISES, INC. 57 Leuning Street, South Hackensack, New Jersey 07606

This statement is intended to a) express general support for efforts to provide legislative assistance to small businesses in industries with a longstanding uniform practice of using independent contractors b) urge the oversight subcommittee to use a bill like H.R. 1972 as the basis of an effort to give long overdue relief to such industries and c) provide the Subcommittee with comments on questions it has raised.

The views expressed are based on extensive experience and expertise in an industry with a uniform practice of retaining independent contractors: the third party advertising sales industry. I have 30 years of experience both as independent contractor and as C.E.O. of my own business in the industry. From 1985-1975. I worked as an independent contractor throughout the nation selling advertising for published materials disseminated free of charge including bookcovers for Catholic and public schools and colleges, on maps distributed by chambers of commerce, on bowling sheets used at bowling alleys, on placemats provided without charge to restaurants, for anti-drug books given free to schools and law officers, for in-room hotel directories provided free to hotels and other similar services.

All the companies with which I have been associated used independent contractors like myself. To this date, persons similarly engaged continue to be retained as independent contractors. In 1975, I started my own business selling educational materials to be provided to schools and law enforcement officials without charge and retained independent contractors who sell the publication advertising. My company now has four offices, services eighteen states and continue to use independent contractors for advertising revenue.

I have also served as an expert witness in the U.S. District Court for the Northern District of Texas in behalf of plaintiff, Advertiser's Dynamic Services Co., Inc., in a case against the IRS. Of note, the court found for plaintiff, a company in the same industry as my company.

The treatment of small business owners in my industry and similar ones which use independent contractors by IRS has resulted in a litany of horror stories of excessive penalties and claims, of inconsistencies in classification, in disregard of the existing statutory intent (e.g., the "Grandfather" clause of Section 530, the Safe Harbor rules), and of onerous bureaucratic tests which often leave small business owners vulnerable to burdens and punishments out of proportion to what is involved and often in disregard of existing rules. How many small businesses have the resources and expertise to resist an IRS judgment whether just or not.

To rely on self-policing by IRS (as with the new classification Settlement Program) is to perpetuate the existing problems. The IRS must be overseen and given direct guidance by the Congress to rein in overzealousness and to prevent injustice.

To this end, I support efforts to reduce the 20 factor test to 3 (as in H.R. 1972) so long as the 3 factor test is defined so as to assure that IRS will not indulge in eccentric interpretation of what constitutes compliance. For example, the criterion of "clear, written agreement" between company and contractor is a subjective criterion unless a model is provided. Moreover "independence" is differently defined in different industries. For example, payment of rent may be appropriate in office-based sales activity (as in travel) but not in my industry which is field-based. Criteria must be sufficiently flexible to include all appropriate industries. Perhaps the existing Congressional latitude afforded the Real Estate industry should be extended to our industry.

We appreciate the desire of IRS to collect taxes to which the government is entitled and their concern that such enforcement is made more difficult by some independent contractors who take liberties. But, it is unfair to make companies which have met their statutory obligations pay for a failure in the collection system for which the company has no responsibility. To relieve this problem, I suggest that, in addition to the regular filing of 1099 information, the law be modified to permit companies to withhold and submit 20% of an independent contractor's compensation to assure subsequent filing and compliance by Independent Contractors. We would be glad to assist IRS in such a fashion which, ultimately, benefits everyone.

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The committee has raised several questions and the ff. comments supplement what has been stated above:

. Are the promised IRS worker classification initiatives adequate to the problem? The history of IRS compliance activities without clear legislative direction and oversight suggests not (see above). Moreover, the classification procedures still leave too wide a latitude for IRS to engage in idiosyncratic interpretation and still penalize small businesses in a disproportionate fashion. Citation of appropriate case law (as in the above mentioned Texas Court) would help.

. Should Section 530 be modified to apply for income tax purposes?

Any Section 530 modification is acceptable so long as it strengthens the rights and protections to which small businesses, in industries which have an historical uniform practice of using independent contractors are entitled. My experience and that of colleagues in my industry indicate that IRS is frequently insufficiently informed as to an industry's scope and, in ignorance, applies a narrow construal to worker classification.

We would strongly support the <u>climination</u> of <u>retroactive</u> penalties particularly where ambiguity of interpretation exists. In particular, to assess retroactive penalties in situations where the independent contractors have met their tax compliance responsibilities is bizarre and unfair.

. Should Safe Harbor rules be classified to address the legislation's liberal intent as guidance to IRS?

IRS must be given explicit guidance particularly where longstanding industry practice is involved.
"Reasonable basis" should be accorded a reasonable interpretation. IRS is, historically, on the margin in determining reasonableness. Without direction, IRS will continue to interpret narrowly and unreasonably.

- Should "significant segment" of an industry be defined?
- Such definition should be industry-specific and might be based on input from experts in that industry (such as myself). IRS tends not to have a clear conception of the industries involved and has often judged small business arbitrarily.
- . I have already addressed Independent Contractor Tax Compliance above. Withholding, as described, would improve compliance without penalizing small business classification rights. This will also address an IRS priority by identifying Independent Contractor by correct S.S. # and easing subsequent collection of S.S. taxes as well.
- . One last item which may interest the committee deals with benefits. I believe Congress should extend to Independent Agents the right to participate in company wide group health and other benefit plans. I believe that this would meet a national priority (making affordable health care available to all) and a compliance priority (encouraging Independent Contractors to meet their statutory obligations so as to participate). It would also add stability to industries with longstanding independent contractor arrangements.

The above views reflect the experience of one who has for thirty years participated in such a large industry using contractors and reflects a desire for strengthening the compliance system in the 3rd party advertising sales industry (estimated to be a five billion dollar industry) while assuring lawful and fair treatment for small businesses in the industry.



INDEPENDENT BAKERS ASSOCIATION

P.O. Box 3731 • Washington, DC 20007 • (202) 333-8190 • Fax (202) 337-3809

STATEMENT OF THE INDEPENDENT BAKERS ASSOCIATION IN SUPPORT

OF H.R. 1972 TO CLARIFY THE EMPLOYMENT TAX STATUS OF

INDEPENDENT CONTRACTORS

Hearings on H.R. 1972 United States House of Representatives Ways and Means Committee Oversight Subcommittee June 4 and 20, 1996

The Independent Bakers Association (IBA) fully supports the efforts of Congressman Jon Christensen (R-NB) and the other cosponsors of H.R. 1972 to clarify the employment tax status of independent contractors. IBA is a Washington, D.C.-based national trade association of 360 small- to medium-sized, mostly family-owned, wholesale bakeries and allied industry trades.

The independent contractor issue has long been an issue of uncertainty and significant unnecessary expense for the baking industry. This is particularly true of small- to medium-sized baking companies who do not have the resources or the time to fight a government agency, such as the IRS, with its unlimited resources and little understanding.

Many bakeries are selling delivery routes and territories to independent distributors. These distributors then purchase product from the bakeries and sell it to retail establishments. They are then able to grow the business through active promotion of the product. This arrangement benefits both the route distributor and the bakery. These independent contractors are particularly affected by the current laws because "bakery drivers" are classified by statute as employees for employment tax purposes, even if they are treated as independent contractors for income tax purposes. Section 3121(d)(3)(A) of the tax code specifically classifies bakery drivers as employees for this purpose. The current law was written in the 1950s when bakeries typically distributed their products door-to-door. This is no longer the case. Instead, these products are often distributed by individuals owning their own territories, who purchase their products directly from the bakeries and who distribute the products to commercial customers for resale.

Application of the statutory employee rules to bakery product distributors creates numerous technical difficulties. First the distributor is required to compute his or her income in two separate ways - once as an employee and once as a self-employed individual - since certain expenses are deductible for self-employed individuals and not for employees. Second, the distributor system, as it has evolved through the years, has no resemblance to a wage-based system. If a bakery is required to treat the distributor as an employee, what amount does the bakery report to the distributor and to the IRS as wages paid? The distributor resells the product to retailers or other wholesalers, the bakery has no information about how much profit the distributor has made. The distributor's income is the profit from the turnover. If the bakery were to report the price paid by the distributor for the product, this would grossly overstate the

amount of income actually earned by the distributor since it would fail to take into account the purchase price of the products and any of the distributor's other expenses. Third, classification of distributors as statutory employees is particularly confusing in light of the fact that many distributors have their own employees. In particular, distributors with large, heavily populated territories may have several employees and operate in corporate form. It is simply unclear how a corporation can be an employee. Finally, the independent contractor form of distribution arose due to its efficient manner of operation for the bakery and potential opportunities for the distributors. By moving incentive away from this form of distribution, current law lowers bakeries' profitability and stifles individual entrepreneurship.

Congressman Jon Christensen's legislation would supersede Section 3121 and allow bakery distributors to be treated as all other independent contractors in our economy. IBA understands the Committee's concern that this legislation should not be a vehicle for individuals and companies to avoid paying taxes. However, we feel that in the case of bakeries, something must be done to change the inconsistencies in the current law. H.R. 1972 would allow bakeries the simple right of being treated like other independent members of the economy.

Robert Fanelli, Chairman Sam Filippine, Vice-Chairman Independent Contractor Committee Independent Bakers Association

STATEMENT OF MICHAEL F. WEISBARD OF CHANDLER SYSTEMS, INC ON BEHALF OF INDIANA SOFTWARE ASSOCIATION

Submission to U.S. House of Representatives Ways & Means Committee / July 5, 1996

STANDING	TU S	OBMIT					
Submitted	by:	Michael	F.	Weisbard,	Chair,	Legislative	Committee

Submitted by: Michael F. Welsbard, Chair, Legislative Committee, the Indiana Software Association ("ISA"). The ISA is an Indiana Not-For-Profit trade association. Mr. Weisbard's office address is c/o Chandler Systems, Inc., 1844 W. Century Way, Indianapolis, Indiana, 46260. Telephone: 317-872-9925.

THIS SUBMISSION IS IN RESPONSE TO HEARINGS HELD BY THE COMMITTEE ON June 4th and 20th, 1996. In Press Releases # 0V-13 and 0V-14, Chairperson Nancy L. Johnson (R-CT), asked concerned citizens to comment upon the impact of Section 530 of the Revenue Act of 1978 (P.L. 95-600) and upon changes to the law as proposed in H.R. 1972 and H.R. 582.

I believe that these comments reflect the feelings and analysis of a majority of the Software Association member firms located in the State of Indiana. This represents something over 65 firms. Opinion and analysis from various member firms was gathered by discussions, phone calls, Internet messages, and review of this submission by interested members of the Assocation.

TAYDAVEDG/	BACKGROUNDS	

The Indiana Software Association ("ISA") is made up of over 65 member firms. The majority of these firms employ programmers and other technology workers in the research, development, and ongoing support of their products and services.

One member firm is publically held and its stock is traded on the NASDAQ. Most of the software development firms within the ISA have employed independent contractors in order to obtain specialized skills and/or to meet project schedules.

The software field is characterized by rapid and frequent change and increasing complexity. This creates constantly-changing needs in our member firms for skills, often just for specific projects or short-term work periods (eg, less than 12 months).

Other allied firms that are ISA members include several law firms with Intellectual Property practices; and several CPA and accounting firms that audit and/or advise software firms that are located in Indiana.

LEGISLATIVE BACKGROUND AND PROBLEMS WITH PRESENT IRS PRACTICES_

The classification of workers as either employees or independent contractors for Federal tax purposes has traditionally been determined under common law (i.e., nonstatutory) rules. Employment classification issues have long been the subject of considerable controversy between taxpayers and the IRS. In the late 1960s, the IRS significantly increased its employment tax audit activities.

In cases when the IRS prevailed in reclassifying workers from independent contractors to employees under the common-law test, the employing business were assessed significant amounts for Social Security and Medicare taxes (FICA) and Federal Unemployment Tax Act (FUTA) taxes on behalf of the reclassified employees. This occurred even though the formerly-independent contractors had fully paid their liabilities for self-employment and income taxes. Further, in many reported cases the back-tax liabilities assessed against businesses were so large that the companies were forced into bankruptcy.

In response to this problem, Congress enacted section 530 of the Revenue Act of 1978 (P.L. 95-600). This provision generally allows a taxpayer to treat a worker as an independent contractor for employment tax purposes, regardless of the actual status under the common-law test, unless the taxpayer has no reasonable basis for such treatment.

This section 530 safe harbor was intended to alleviate what Congress perceived as overly zealous pursuit and assessment of taxes and penalties by the IRS against employers who had, in good faith, misclassified their employees as independent contractors. The legislative history of this provision indicates that the Congress intended for the section 530 safe harbor relief to be liberally construed and applied by the IRS.

In recent years the IRS has again stepped up its enforcement efforts with regard to employment tax issues, particularly with regard to small businesses with assets of \$3 million or less. However, many small businesses undergoing employment tax audits do not have the financial resources necessary to litigate adverse determinations by the IRS even where the IRS's determination is erroneous. Moreover, those who do appeal IRS efforts to reclassify their workers and successfully prevail in litigation often incur hundreds of thousands of dollars in management costs, as well as accountant and attorney fees, during the examination and administrative appeals phases.

The Internal Revenue Code section 7430 provides for the payment of attorney fees and certain costs by the Federal Government when taxpayers substantially prevail on the merits of their tax disputes with the IRS and the IRS's position was not substantially justified. However, this provision only applies to litigation costs incurred in connection with a court proceeding. The management costs are rarely, if ever, recovered.

At the 1995 White House Conference on Small Business, a legislative solution to the problem of the IRS's aggressiveness in recharacterizing independent contractors as employees was ranked the number one priority among small businesses.

Several bills have been introduced in this session of Congress to clarify the rules for classifying workers for Federal tax purposes, including H.R. 1972, the "Independent Contractor Tax Simplification Act of 1996," introduced by Representative Jon Christensen, and H.R. 582, the "Independent Contractor Tax Fairness Act of 1995," introduced by Representative Jay Kim.

The Subcommittee hearings in June examined current problems with regard to classification of workers for tax purposes, including the IRS's handling of employment tax audit issues and reasons for its failure to liberally construe and administer the safe harbor rules created by section 530 of the Revenue Act of 1978. In addition, the Subcommittee received testimony on proposed legislation to clarify the tax laws relating to worker classification (e.g., H.R. 1972 and H.R. 582).

The sponsor of H.R. 1972, Rep. Jon Christensen (R-Neb), has written a concise description of his bill in the June 6th edition of the <u>Wall Street Journal</u>, which we quote:

"Unlike past attempts to resolve the issue, this legislation does not define who is an employee, but rather who is an independent contractor. To qualify under this alternate test, an individual must fulfill not 20 factors, but three: investment, independence and contract.

First, a worker must invest in his own training or assets. Second, the worker has to show some independence from the agency, for example by paying a fair market rent for use of the service recipient's place of business. Finally, the parties must describe their relationship in a clear written agreement."

EXPECTED IMPACT OF PROPOSED CHANGES ON TAXPAYERS' BUSINESS PRACTICES

We forsee several benefits from creating greater certainty as to "Independent Contractor" versus "Employee" status for workers in the field of software technology:

- (1) More mobility, enabling people having critical skills to move to projects and companies where they're most needed, to the benefit (efficiency) of the American economy.
- (2) Reduced costs to software development firms, resulting in more cost-efficient operation. Again, this provides a net benefit to our economy and our nation's competitive position.
- (3) The proposed legislation (H.R. 1972) would provide a clearer and statutory definition as to who is an independent contractor. Providing an alternative test to the present complex IRS "20-Factors" questionnaire will reduce audit and appeals costs for both the Internal Revenue Service and for businesses.

The question may be raised, as to whether the "contract" requirment would be a new burden to software firms and independent contractors in this field. It is our belief that no new burden would be created. Under section 530, a taxpayer is relieved from Federal employment tax liability when it can demonstrate that, in classifying its workers as independent contractors, it reasonably relied upon: "a long-standing recognized practice of a significant segment of the taxpayer's industry".

Many firms that engage independent contractors already require contractual documents that specify Intellectual Property Rights and establish Non-Disclosure obligations. Thus, the relevent existing practice in the software field include significant aspects of the "written contract" as required in H.R. 1972.

RECOMMENDATIONS -	£	REQUESTED	ACTION
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- This legislation (H.R. 1972) should be passed so as to bring long-needed certainty and simplification to this area.
- 2. The rules should be revised to encourage labor (skills) mobility within the software industry. It is in the national interest to encourage greater mobility of educated, skilled technology workers between companies. It is also clearly in the interest of individuals to be able to undertake work among a variety of firms as industry needs change.
- 3. The Congress should protect, by law, a long-standing, bonafide and recognized practice of a significant segment of the software (e.g., taxpayers') industry.
- 4. The section 530 safe harbor rules should be modified to apply to income tax purposes as well as employment tax purposes. The basis for taxation arises out of a singular transction and therefore should be treated uniformly and consistantly.
- 5. The Indiana Software Association prefers H.R. 1972 over H.R. 582, the "Independent Contractor Tax Fairness Act of 1995" introduced by Representative Jay Kim, for two reasons:
 - H.R. 1972 appears clearer in its text, intent, and expected implementation; and
 - (2) H.R. 1972 appears to be a simpler solution to the issues investigated by the committee. Simplicity is a virtue here, leading to better complience and reduced IRS costs to audit and secure enforcement of the law.

Respectfully Submitted:

Michael F. Weisbard

for the Indiana Software Association

cc: Indiana Congressional Delegation (listed by district)

Rep. Peter J. Visclosky
Rep. David McIntosh
Rep. Tim Roemer
Rep. Mark Souder
Rep. Steve Buyer
Rep. Dan L. Burton
Rep. John T. Meyers
(Indiana 1)
(Indiana 2)
(Indiana 3)
(Indiana 4)
(Indiana 6)
(Indiana 7)

Rep. John Hostettler (Indiana 8)
Rep. Lee H. Hamilton (Indiana 9)

Rep. Andrew Jacobs, Jr. (Indiana 10)

INTERNATIONAL ASSOCIATION FOR FINANCIAL PLANNING 5775 Glenridge Drive, ME, Suite B-300, ATLANTA GA 30328

WRITTEN TESTIMONY ON WORKER CLASSIFICATION FOR TAX PURPOSES

HOUSE WAYS AND MEANS SUBCOMMITTEE ON OVERSIGHT JUNE 20, 1996 HEARING

This statement is submitted in connection with the hearings of the Subcommittee on Oversight, held on June 4 and June 20, 1996, on current issues relating to the classification of workers as employees or independent contractors for Federal tax purposes.

The International Association for Financial Planning (IAFP) is the oldest and largest membership association serving financial planning. Our over 14,000 members are guided by the principle that everyone needs objective advice to make good financial decisions. The financial planning process is client-centered, rather than product-centered and includes an analysis of the client's current situation; determination of the client's needs, goals and objectives; formulation of a written plan of action, and implementation and ongoing review of that plan. The membership includes over 100 broker/dealer firms. There are over 75,000 individuals associated with these firms as registered representatives, most of whom are actively engaged in providing financial planning services to the public. These services include asset management, retirement and estate planning, budgeting, accounting, tax return preparation, processing of transactions involving investment assets (including stocks, bonds, mutual funds, variable annuities, limited partnership interests and real estate), and insurance brokerage.

This statement addresses the application by the IRS of the 20-factor common law test --- and in particular those factors that indicate whether a service recipient "controls" the manner and means by which the worker performs the work -- to the securities industry. In the securities industry, as in many regulated industries, government and self-regulatory agencies, such as the National Association of Securities Dealers (NASD) issue detailed rules and regulations on how the work must be done. In the securities industry, these rules are designed primarily to prevent fraud, undue influence and misrepresentation in the sale of securities. The securities agencies also impose upon the broker/dealer the duty to "supervise" the sales activities of the registered representatives associated with it to ensure compliance with these rules and regulations. The IRS has generally attempted to treat activities undertaken by a broker/dealer reasonably to comply with this quasi-governmental duty to supervise as evidence of control within the intendment of the common law test.

We respectfully urge Congress to clarify the law to state explicitly that activities undertaken by a service recipient reasonably to satisfy the duty imposed on it to supervise the worker's activities to ensure compliance with regulatory rules and regulations should be a neutral factor and should not be treated as evidence of employee or independent contractor classification.

A. The Clarification Is Necessary To Prevent the IRS From Misapplying the Common Law Test to Reclassify As Employees Workers In Regulated Industries Who Have Historically Been Treated As Independent Contractors.

The securities industry provides a prime example of how the IRS has misapplied the common law control test to reclassify workers as employees in a regulated industry.

In the securities industry, both the registered representative and the broker/dealer with which he or she is associated are subject to the rules and regulations of the Securities Act of 1933, the Securities and Exchange Act of 1934, and the rules of self regulatory organizations such as the NASD.

Under these rules, a broker/dealer has the duty to supervise the registered representative with respect to his or her adherence to the regulations of the Securities and Exchange Commission and the NASD.

Under the regulatory regime established by the SEC and self-regulatory organizations, the broker/dealer, in effect, acts as a surrogate for the regulators --- by monitoring and policing sales activities to assure that the registered representatives do not engage, or come close to engaging, in fraudulent, misleading, or overreaching practices. However, this is a far cry from exercising control to ensure that the manner and means employed by the registered representative in performing his or her work are best suited to serve the interests of the broker/dealer. In this context, the do's and don'ts of the broker/dealer are nothing more than an implementation of the do's and don'ts of the regulator. They are not controls which are designed to maximize the profits of the broker/dealer's business. To the contrary, they represent additional costs to the broker/dealer, which it is required to bear to maintain its registration.

This may be illustrated by the relationship between broker/dealers and registered representatives in the financial planning industry. Many financial planners are licensed as registered representatives so that they can initiate securities transactions on behalf of their clients. In order to provide this service, a financial planner is required by law to be associated with a broker/dealer who processes the transactions, shares in the sales commissions, and is charged with the responsibility of supervising the transactions to assure compliance with securities rules and regulations. As described above, however, financial planners perform a wide range of financial services for their clients, of which the handling of securities transactions may comprise a small part. The broker/dealer generally has no involvement in these other activities --- it does not exert any control over them, and does not receive any remuneration from them.

Financial planners generally have substantial investments in facilities (either owned or leased) and equipment; they decide their own work hours, the portion of those hours that is devoted to the sale of securities, and the content and order or sequence of their work (except to the extent they follow procedures established by the broker/dealer with regard to securities transactions); they hire their own assistants; they do not perform the work on the broker/dealer's premises but rather on premises owned or leased by them or by another financial planner; they furnish their own tools and materials; and they have the opportunity for profit and risk of loss.

However, even though many of the common law factors point strongly towards independent contractor status, the IRS has continued to focus on the broker/dealer's "duty to supervise" registered representatives to assure their compliance with the securities laws and has sought to base reclassification on this factor. In doing so, the IRS has failed to distinguish between controls that are imposed on a worker by the recipient of his or her services to enhance or maximize the benefits to the recipient and controls that are imposed on the worker to comply with government or other regulatory requirements. In the latter case, it is the government or regulatory organization, not the service recipient, that is concerned with the "manner and means" by which the worker performs the job.

We therefore propose clarifying the common law test to make it clear that supervisory activities imposed upon, and reasonably undertaken by, a service recipient to assure that the worker complies with government or self-regulatory agency rules and regulations should not be treated as evidence of independent contractor or employee status.

B. There Are Sound Policy Reasons for Adopting the Proposed Clarification.

The IRS's misapplication of the common law control test to situations, such as described herein, arising in regulated industries has created a tension in these industries between tax and regulatory policies. While the service recipients are encouraged (indeed required) by the industry regulators to implement and strengthen existing supervisory procedures to assure compliance with agency rules and regulations, they are discouraged from doing so because of the IRS's reliance on such procedures to reclassify the workers as employees. These conflicting policy objectives would be brought into harmony under the proposed clarifying legislation.

C. The Proposed Clarification Is Consistent With the Case Law.

Although we are not aware of any case law that addresses this issue in the tax area, case law in other relevant areas holds that actions taken to comply with government regulation are not considered "controls" imposed by the service recipient under the common law test.

For example, North American Van Lines, Inc. v. N.L.R.B., 869 F.2d 596 (D.C. Cir. 1989), involved the employee/independent contractor classification of truck drivers for purposes of the National Labor Relations Act. There the court held that the trucking company's "efforts to ensure the worker's compliance with government regulations even when these efforts restrict the manner and means of performance, do not weigh in favor of employee status." The court reasoned that the trucking company "cannot evade the law . . and in requiring compliance with the law [it] is not controlling the driver; [i]t is the law that controls the driver." Id. at 599.

Similarly, in <u>Local 777, Democratic U. Organizing Com. v. N.L.R.B.</u>, 603 F.2d 862, 875 (D.C. Cir. 1978), in responding to the Board's argument that the "extensive regulation of taxi drivers by municipal ordinance gives the companies control over the drivers' conduct on the job," the Court stated that "Government regulations constitute supervision not by the employer but by the state."

The proposed clarification is designed to ensure that, in the tax area as well, the IRS adheres to this established legal doctrine.

D. Conclusion

We appreciate the opportunity to present this issue of great significance to the securities industry and urge Congress to clarify current law to prevent the IRS from misapplying the common law test to find employee status on the basis of a broker/dealer's duty to supervise to ensure compliance with the securities laws and regulations.

STATEMENT OF THE INTERNATIONAL BROTHERHOOD OF TEAMSTERS ON EMPLOYMENT CLASSIFICATION ISSUES

This statement is submitted by the International Brotherhood of Teamsters ("IBT"). While the IBT did not present oral testimony at the June 4, 1996 Subcommittee hearing, its absence from the hearing should in no way be interpreted as a lack of interest in the subject of employment classification issues in general, and H.R. 1972, in particular. As a labor organization which represents approximately 1.4 million members, the IBT has a very strong interest in any legislation which affects worker classifications. The IBT submits this statement in opposition to H.R. 1972.

BACKGROUND

The Internal Revenue Code does not currently set forth criteria for classifying a person as an employee or an independent contractor. Rather, workers are classified as either employees or independent contractors by statute, under a "safe harbor" provision contained in section 530 of the Revenue Act of 1978, or by applying a subjective test using a list of twenty questions developed by the Internal Revenue Service ("IRS") in the context of litigated cases.

SUMMARY OF POSITION

The stated purpose of H.R. 1972 is to clarify the definitions of employee and independent contractor for purposes of federal tax laws. However, the proposed language fails to accomplish this purpose. Indeed, its real purpose is to make it easier for employers to seek to classify their workers as independent contractors rather than employees, thereby leaving many legitimate employees without benefits to which they are legally entitled. H.R. 1972 also has the potential to deprive the federal government of billions of dollars in employment tax revenues. H.R. 1972 is a poorly crafted and unnecessary bill which, if enacted into law, would be harmful to thousands of hard-working Americans and potentially destructive of efforts to balance the federal budget. It should not be approved by the Subcommittee.

DISCUSSION

H.R. 1972 Creates More Ambiguity, Not Less

H.R. 1972 would substitute a three-part statutory test for the IRS' twenty question test to determine whether workers are employees or independent contractors. More specifically, H.R. 1972 provides that in order to be considered an independent contractor the worker or employer must demonstrate that:

- One of the following five requirements are met:

 (i) the worker has made significant investments in assets and/or training; (ii) incurs significant unreimbursed expenses; (iii) agrees to perform the services for a particular amount of time or to complete a specific result and is liable for damages for early termination without cause; (iv) is paid on commission, or (v) purchases products for resale;
- 2. One of the following two requirements are met: (i) the worker has a principal place of business, does not primarily perform services in the service recipient's place of business, or pays a fair market rent for use of the service recipient's place of business, or (ii) the worker is not required to work exclusively for the employer and the worker's services are performed for others, the worker's services are marketed to others, or the services are performed under a trade name; and

 The services are provided pursuant to a written contract clarifying the independent contractor status of the service provider.

This new three-part test is no less ambiguous than the old test in that it fails to define several key terms contained in the above-quoted language. For example, it is not at all clear what would constitute "significant investments," "significant unreimbursed expenses," or "a particular amount of time." As a result, confusion and litigation between taxpayers and the federal government is certain to continue or even increase. Taxpayers and the IRS are certain to interpret these vague terms in a way most favorable to their respective positions. Resolution of which interpretation is correct will inevitably require further litigation. Accordingly, H.R. 1972 does not serve its stated purpose of clarifying the law and reducing litigation between taxpayers and the government.

The effect of this ambiguity will be to encourage employers to interpret the new law broadly to allow them to classify or re-classify their workers as independent contractors rather than employees. Until such employment classification issues are resolved through litigation, many workers will lose their status as employees, with the significant resulting consequences discussed below.

II. The Real Purpose of H.R. 1972 Is to Make It Easier to Classify Employees as Independent Contractors

Instead of clarifying existing law, H.R. 1972's real purpose is to make is easier for employers to seek to classify or re-classify their workers as independent contractors rather than employees. H.R. 1972's standards for independent contractor status arguably are relatively easy to meet. For example, if a worker has some college education or vocational training (arguably a significant investment in assets and/or training), performs services for at least two people (the worker does not work exclusively for the employer), and has a written contract with each such person, the worker could be considered an independent contractor. This lower threshold, coupled with the safe harbor provision of section 530, gives employers a great deal of discretion in classifying or re-classifying their workers as independent contractors rather than employees.

III. Consequences of Employment Classification

Classification of a worker as an independent contractor rather than an employee has significant consequences for both the employer and the employee. By classifying a worker as an independent contractor, the employer escapes its liability for payment of federal taxes and social security with respect to that worker. It also permits the employer to exclude the worker from insurance, retirements plans and other benefits available only to employees. While in the short run this may save employers some money, in the long run, it would be a drain on our economy.

Independent contractors have to provide for their own insurance, which is generally more expensive when not done as part of a large group plan. Many independent contractors may be uninsured or underinsured because they are unable to afford the proper amount of insurance. We as a society end up paying for that deficiency through emergency, rather than preventative, medical care and higher insurance premiums.

In addition, independent contractors may not be able to set up their own retirement plans because of the significant expense and burden involved. By contrast, participation in an employer's 401k or other group retirement plan is simple and convenient and the administrative costs are generally borne by the employer. The burden and expense of setting up an individual plan may discourage independent contractors from saving for their retirement. In addition, even if independent contractors make the required investment to set up an independent retirement plan, certain investment to set up an independent contractors wake the required investment to set up an independent retirement plan, certain investment options may be closed to them or more expensive because they do not have sufficient buying power. Accordingly, independent contractors will have a more difficult time saving and investing for their retirement than they would if they were able to participate in an employer's 401k or other retirement plan. As our population ages and stretches the limits of social security, it will become increasingly important that our elderly have an adequate retirement plan of their own.

Independent contractors also may not be eligible for other benefits, such as life and disability insurance, paid vacation and sick leave, unemployment compensation, worker's compensation, etc. Their wages may be lower and they will be unable to organize a union to protect their rights and better their employment situation. Hence, the potential financial and emotional consequences of being classified as an independent contractor rather than an employer are tremendous.

In addition, if unscrupulous employers are able to secure lower costs by stretching the statutory language to classify their workers as independent contractors, such employers will have an unfair competitive advantage over employers who retain their traditional employees and pay them for the benefits to which they are entitled.

Classifying workers as independent contractors also means that employers avoid paying federal taxes and social security for those workers. It is well established that the compliance rate for reporting and payment of taxes is much higher in cases where the wages are paid to an employee rather than an independent contractor. Joint Committee on Taxation, <u>Present Law and Issues Relating to Classification of Workers as Employees or Independent Contractors</u> (JCX-23-96), June 3, 1996, at p. 25. Furthermore, an independent contractor classification may reduce the amount of taxes owed. <u>Id.</u> at pp. 34-35. Hence, under H.R. 1972, the federal government stands to lose billions of dollars in potential tax revenue.

CONCLUSION

The IBT recognizes the plight of employers and legitimate independent contractors who suffer from ambiguous laws and zealous Internal Revenue Service agents. Accordingly, the IBT supports proper reform of the tax code to address these issues. However, H.R. 1972 is not the solution.

UNITED STATES HOUSE OF REPRESENTATIVES COMMITTEE ON WAYS AND MEANS SUBCOMMITTEE ON OVERSIGHT HEARING ON EMPLOYMENT CLASSIFICATION ISSUES

JUNE, 1996

STATEMENT OF MITCHELL ROUSE PRESIDENT INTERNATIONAL TAXICAB AND LIVERY ASSOCIATION

The International Taxicab and Livery Association ("ITLA") represents more than 800 small businesses that provide taxicab, livery ("executive sedan"), and limousine service in communities across America.

As an association of small businesses, most of whom lease vehicles to drivers who are classified by the IRS as independent contractors under the common law "right to control" test, ITLA strongly supports both the purpose and the provisions of HR 1972. We applaud Congressman Christensen and his more than 210 co-sponsors for their willingness to tackle a topic that has vexed both tax collector and taxpayer for 25 years.

With minor changes to clarify its application to the passenger transportation industry, HR 1972 should be enacted because it would clarify the law, leading to higher rates of tax compliance, more evenhanded enforcement by the IRS, and, in our industry, improved taxicab and livery service. (We have provided our recommended changes to Congressman Christensen.)

Company-driver contracts

The majority of taxicab and livery businesses in the United States lease their vehicles (using written leases) to drivers who are classified as independent contractors, pursuant to Rev. Rul. 71-572 (Situation 2), 1971-2 C.B. 347 (copy attached). Under Situation 2, if the lease is for a fixed rate, the company has no interest in the fares and tips received by the driver, and the company is not otherwise entitled to control the driver and the conduct of his work, the driver is deemed to be an independent contractor.

Changes in the law are required

With a few notable exceptions, ITLA members have been able to avoid classification controversies with the IRS because of the existence of Rev. Rul. 71-572. However, the IRS' interpretation of the common law "the right to control" test has been so stringent that it has resulted in deterioration of service in the taxicab industry. This is because companies are uncertain whether, for example, they can require the driver to adhere to a dress code, or to satisfy particular standards of cleanliness and courtesy towards passengers. These facts are not addressed in Rev. Rul. 71-572, and one court has ruled that, for purposes of the National Labor Relations Act, drivers who were subject to a dress code were employees. This is important both to taxicab passengers and drivers. A driver's poor conduct and/or slovenly appearance has

^{*} City Cab of Orlando, Inc., v. N.L.R.B., 628 F.2d 261, 265 (D.C. Cir. 1980). But see Local 777, etc. v. N.L.R.B., 603 F.2d 862, opinion on rehearing, 603 F.2d 891, 902 (D.C. Cir. 1978) dress restriction limited to a "no sandal" rule is a "very minimal" control). That the same court has drawn fine lines over the extent of a dress code is itself evidence that the law needs to be clarified.

a negative impact on passengers who will seek to meet their transportation needs in an alternate manner (e.g., rental cars, executive sedan services, airport shuttle vans). Less obvious is the adverse consequence suffered by the professional taxicab drivers who provide quality service. Drivers in the same company may lose the opportunity to serve that passenger in the future due to the strong probability that the passenger will select a different taxicab company, and all taxicab drivers are harmed as dissatisfied passengers simply use taxicabs less often.

While the IRS' recent initiatives, to improve agent training and to resolve classification issues more quickly, are helpful, they do not address the underlying problems: lack of clarity in the law and the IRS' institutional bias against companies that engage independent contractors.

Clarify the law. The Subcommittee has heard the litary of complaints by numerous witnesses about the difficulty of complying with the common law test, and how "errors" in judgment can lead to assessments by the IRS that are overturned, if at all, only after a long, arduous, and expensive battles with the IRS bureaucrats or in the court. This should not be! The "bright-line" test in HR 1972 will not only help both businesses and the IRS to properly classify workers, but will enable businesses that engage independent contractors who perform services for third parties, including taxi, livery, and limousine drivers, to require those independent contractors to satisfy standards of conduct that do not materially affect the independence of the driver.

Eliminate arbitrary enforcement. Enactment of HR 1972 would also help eliminate the litary of complaints about arbitrary and capricious enforcement by the IRS. For example, in 1975, one taxi company obtained a private letter ruling from the IRS National Office, concluding that the drivers to whom it leased taxicabs were not employees. Ten years later, the company was audited, and the collections officer, in violation of the IRS' own rules, reclassified the drivers and proposed to assess the company \$3 million in taxes and penalties. Although this action was subsequently overruled by the IRS National Office, the process took three years and over one hundred thousand dollars in legal fees. HR 1972, if properly followed by the IRS, would put a stop to this kind of nonsense.

Help new industries comply. Finally, HR 1972 would help many companies in industries that have grown up since 1978, and thus, do not have published revenue rulings to guide their classification of workers. In particular, HR 1972 would help ITLA members who lease limousines and executive sedans to drivers. Although the economic arrangements with these drivers are usually quite similar to those with taxi drivers, the lack of any published ruling with respect to these drivers has left these companies at the mercy of the IRS. Thus, the limousine industry has fought a series of battles with the IRS, wasting many thousands of dollars to fight battles that will never arise if HR 1972 is enacted.

Conclusion

ITLA urges the Subcommittee to act favorably on HR 1972 and recommend its approval by both the full Ways and Means Committee, as well as the House of Representatives. Please seize this important opportunity to clarify the law, reduce the cost of tax administration and compliance, and improve service in the passenger transportation industry.

ITIA appreciates the opportunity to submit this statement, and will continue to constructively work with the Congress to reach an appropriate resolution of this issue.

Congress of the United States

Mashington, DC 20515

STATEMENT OF CONGRESSMAN TOM LANTOS ON HR 510, THE MISCLASSIFICATION OF EMPLOYEES ACT

June 20, 1996

Mr. Chairman and members of the Committee, thank you for giving me the opportunity to say a few words about the employee/independent contractor classification or the classification of workers.

As I look over the witness list for today's hearing, I see that you have before you an impressive panel who will no doubt describe to you some of the important reasons why Congress should take another look at how workers are classified for Federal income and employment tax purposes, as well as for many non-tax purposes. You might hear from witnesses who will tell you that confusion with employee classification rules can lead to costly disputes with the IRS with devastating effects for small businesses. These costs include, among others, assessments of back taxes, interest and penalties for businesses who misclassify workers as independent contractors, as well as the legal costs involved with coming into compliance with or for defending against an IRS audit.

As you probably know, Chris Shays and I became interested in the classification of workers several years ago when we served together on the Employment and Housing Subcommittee of the Government Operations Committee. We found that the misclassification of workers as independent contractors instead of employees is a pervasive and serious problem which impacts employers, workers, and Federal and State governments. We found that the current means for determining employment status has had several negative effects: one, it results in similarly situated employers being treated very differently under tax law; two, it allows -- and actually encourages -- businesses to undercut competitors through unfair practices; three, it leaves some workers exploited and unprotected; and four, it deprives the Federal government of significant revenue.

As you know, under current law, workers are classified as either employees or independent contractors in one of three ways. First, some workers are explicitly categorized as either employees or independent contractors by statute. Second, workers may be classified as independent contractors under statutory "safe harbors" enacted in Section 530 of the Revenue Act of 1978. Third, if a worker is not classified statutorily, and cannot be classified under the statutory "safe harbors", then the worker is classified by applying a very subjective common law test. Most workers fall under this third category.

I would like to make clear that I agree with and recognize the appropriate and valuable roles of those who work as independent contractors. This country has benefitted greatly from the spirit and independence of the self-employed individual and I do not think there is anyone who wants to stifle the creativity of these individuals. It is the misuse of the independent contractor status and its serious adverse effect on both employer and worker that concerns me. The misclassification of workers affects the unsuspecting worker, it affects the honest businessman trying to compete with a competitor who has misclassified his workers, and it affects the federal budget deficit. Our bi-partisan legislation, HR 510, the Misclassification of Employees Act, would remedy some of the unintended effects of the current law.

First, current law gives some companies an unfair competitive advantage over other companies in the same industry by permitting employers to misclassify workers if they have a "reasonable basis" for classifying employees as independent contractors. An employer may rely upon a prior IRS audit, including audits not made for employment tax purposes, in holding a reasonable basis for classifying workers. It makes no sense to permit the wrongful classification of workers based on a previous audit which may have had nothing to do with the issue of worker classification. Our legislation eliminates the "safe harbor" provisions which allows the misclassification of employees to continue. We thus restore a level playing field and eliminate the unfair competitive advantages which arise due to the misclassification of workers.

Second, because the common law test is extremely subjective, employers have trouble in properly determining worker classification, and revenue agents often classify workers differently even where the underlying circumstances of their employment are the same. Since a large part of the misclassification of workers is due to a lack of understanding of worker classification, clearer rulings and definitions will eliminate a tremendous amount of uncertainty in this area. Our legislation eliminates the restrictions of the IRS to draft regulations and rulings on the employment status of workers.

Third, employers who have unintentionally misclassified workers should be given the incentive to come into compliance. Our legislation offers a one-year ammesty to employers who have misclassified workers on the basis of a good faith interpretation of common law or of Section 503. This provision removes the devastating possibility of large assessments for back taxes, interest and penalties and ensures compliance in the future.

Fourth, misclassification can have a devastating effect on the unsuspecting worker. As a independent contractor, a worker may receive a higher take-home pay and may be allowed to deduct more business expenses from income taxes. But the loss of financial benefits and of the many protections which are provided to employees can be catastrophic in cases of illness, unemployment and retirement. For example, there is no unemployment compensation for the independent contractor to fall back on between jobs. Health insurance is an individual responsibility and is usually far more costly than an employer's group policy. In the case of work-related injury or illness, there is no worker's compensation available. HR 510 would require prime contractors to notify independent contractors of all their tax obligations and other statutory rights and protections.

Mr. Chairman, our investigation found that the economic incentives for businesses to misclassify workers as independent contractors are huge. An employer who misclassifies a worker as an independent contractor escapes many obligations, including paying social security taxes, unemployment taxes and workers compensation insurance, withholding income taxes and providing benefits such as vacation, sick and family leave, health and life insurance, pensions, etc. Most employers are honest, but the law abiding employer is put at a serious disadvantage since he or she cannot compete on a level playing field with those who illegally cut their labor costs. Law abiding employers will not be able to compete fairly until we provide more clear, objective standards by which businesses and the government can determine whether an individual is an employee or an independent contractor.

Lastly, and perhaps most importantly in these times of scarce federal dollars, billions of dollars in federal and state tax revenues are being lost as a result of the intentional misclassification of workers. This is one of the few remaining areas where we can help balance the federal budget deficit without further cutting government services or levying new taxes. A recent Coopers and Lybrand study found that at least 35 billion dollars in legitimate tax revenue over 9 years will be lost by the federal government due to the misclassification of employees. At a time

when critical services are on the chopping block, we can no longer allow this waste and abuse to continue. We must take steps to curb the continued misclassification of employees. We must enact HR 510, the Misclassification of Employees Act. I respectfully request that a summary of HR 510, the Misclassification of Employees Act, be entered into the record.

H.R. 510

Section 1. Section I provides that the short title of the bill is the "Misclassification of Employees Act."

Section 2. Section 2 would remove an impediment to many employers' correcting the misclassification of their workers. Section 2 would waive liability for prior employment taxes for past periods if the employer met five requirements:

- (A) The employer treated the worker as an independent contractor for purposes of employment taxes.
- (B) The employer's treatment of the worker as an independent contractor was based on a "reasonable good faith misapplication of the common law rules" using for determining employment relationships.
- (C) All the employer's federal tax returns consistently treated the worker as an independent contractor.
- (D) The employer and any predecessor employer treated all similarly situated workers as independent contractors for all periods after 1977.
- (E) The employer enters a closing agreement with the Internal Revenue Service agreeing to treat the worker and all similarly employed workers as employees, and to file all federal employment tax returns with respect to the workers as if they were employees.

The employer would have one year from the date of enactment of the bill to enter the closing agreement with the IRS. The waiver of past liability would expire one year after enactment of the bill. The five requirements would amend Internal Revenue Code (IRC) § 3509 by adding a new subsection (e).

Section 2(a)(2) of the bill would not amend the Internal Revenue Code, but it would require the Internal Revenue Service to monitor compliance of each closing agreement for at least five years after the agreement is entered into. The monitoring would include payments to the individual workers covered by the closing agreement as well as wages paid to other employees and independent contractors.

Section 2(b) of the bill would modify Section 530 of the Revenue Act of 1978, a tax statute which is not part of the Internal Revenue Code. The bill would tighten up the safe harbors slightly, and would eliminate one safe harbor which has proved to be a significant impediment to IRS reclassification of misclassified workers. It would reestablish safe harbors for technical service workers.

Paragraph (1) of section 2(b) would amend section 530 of the Revenue Act of 1978 to provide that a worker would be deemed to be an independent contractor if the employer has a reasonable basis for treating the worker as an independent contractor. Present law deems a worker an independent contractor unless the employer has no reasonable basis for treating the worker as an independent contractor.

Paragraph (2) would amend the statutory standards for treating workers as independent contractors. Under the bill, section 530(a)(2) would be amended to contain a list of reasonable bases for treating a worker as an independent contractor. Under the bill, an employer would have a reasonable basis for treating a worker as an independent contractor only if the employer reasonably relied on one of the following:

- (a) judicial precedent, published rulings, technical advice or a letter ruling furnished to the employer [this is the same as present law];
- (b) an IRS audit conducted solely for employment tax purposes within three years before the period in question, which audit included an examination for employment tax purposes of workers holding substantially similar positions to the worker in question, and following which audit the employer was notified in writing by the IRS that the employer had classified the workers correctly, and the IRS notification was not revoked before the period in question [this is substantially different from current section 530]; or
- (c) long-standing, recognized practice of a significant segment of the industry in which the worker was engaged [this is the same as present law].

Subsection 2(c) would essentially repeal section 1706 of the Tax Reform Act of 1986. This would permit employers of technical service workers to take advantage of the safe harbors in section 530 of the Revenue Act of 1973, if they could meet the requirements.

Subsection 2(d) would repeal the prohibition against the IRS issuing regulations and rulings on employment status, originally enacted as part of section 530 of the Revenue Act of 1978.

Subsection 2(e)(1) would amend IRC § 6041 to require that additional information be provided on the Form 1099 furnished by businesses to providers of services worth more than \$600 per year. The 1099 would be required to include information that explains

- the payor is treating the payee as not being an employee and the payee may be liable for self-employment taxes;
- 2) the procedure for obtaining IRS review of employment status, if the payee believes that he or she should be properly treated as an employee;
- 3) the payee is not eligible for employee fringe benefits and may lose protections or benefits under federal laws relating to fair labor standards, occupational health and safety, civil rights, unemployment insurance, and workers' compensation; and
- 4) tax benefits for the self-employed such as retirement plans and deduction for a portion of the cost of health insurance.

Similar information would be required to be furnished to service providers and direct sellers under IRC § 6041A by bill subsection 2(e)(2).

For the provisions in section 2 of the bill, subsection 2(f) would establish a general effective date beginning 120 days after the date of enactment. The modifications of the safe harbor provisions and the termination of the treatment of technical personnel would be effective for "periods ending on or after the date which is 120 days after the date of enactment" of the bill. It is not entirely clear whether the word "periods" refers to taxable years or to periods for which deposits of employment taxes are required to be made.

Section 3. Section 3 of the bill would amend IRC § 3304(a) to require that state unemployment compensation laws use the same definition of employee as is used under federal law as set out in IRC § 3306(i). This definition is nearly identical to the social security tax definition. This provision would take effect on the 180th day after the date of enactment of the bill, unless the state legislature had not been in session for at least 30 calendar days during the 180 days between enactment and the effective date. In such a case, the effective date would be 30 days after the first day on which the legislature is in session on or after the 180th day.

THE U.S. HOUSE OF REPRESENTATIVES COMMITTEE ON WAYS AND MEANS SUBCOMMITTEE ON OVERSIGHT HEARING ON EMPLOYMENT CLASSIFICATION ISSUES

Statement of the Mechanical Contractors Association of America June 4, 1996

The Mechanical Contractors Association of America (MCAA) represents businesses providing mechanical construction services in the residential, commercial, and heavy industrial construction markets nationwide. MCAA member firms compete in both public and private sector markets and perform services as both prime contractors and subcontractors.

The highly skilled craft labor employed by MCAA member firms is supplied under local collective bargaining agreements negotiated by 75 local MCAA affiliates and local unions of the United Association of Journeymen and Apprentices of the Plumbing and Pipe Fitting Industry of the United States and Canada (UA). MCAA member firms also provide equipment maintenance and services under the National Mechanical Equipment Service and Maintenance Agreement negotiated with the UA at the national level and MCAA's subsidiary, the Mechanical Service Contractors of America.

Support stringent classification standards

MCAA supports, without reservation, efforts to stem the workforce degradation that is directly the result of misclassification of employees as independent contractors. Similarly, MCAA supports efforts to narrow the excuses from liability for misclassification to remove incentives for abuse. Moreover, MCAA supports attempts to assure full payment of taxes by independent contractors.

Even with this unqualified support for the legislative objective, MCAA does not support the two legislative proposals under consideration today (H.R. 1972 and H.R. 582). In short, MCAA is concerned that the classification criteria set out in either proposal, when applied to the highly trained, highly mobile skilled construction workforce, would jeopardize the entire structure of training, health and welfare, pension, and other workforce development and retention benefits that are based on hours of covered employment.

Protect industry workforce development structures

We acknowledge the tremendous change in workforce patterns in this country in recent years, and agree that individual responsibility for career development can be beneficial for individuals in all types of careers - production and administrative and professional occupations as well. However, we also note that not all trends in work flexibility are necessarily beneficial. Much of the growth of the contingent workforce, and the concomitant growth of independent contractor status, leads to a tenuous attachment to

employment and the economy - with fewer benefits - which in turn accounts for a high level of underemployment in the economy overall.

In the union sector, trade union and multiemployer groups in local collective bargaining have built and maintain a system of apprenticeship training, health and welfare, pension benefits, and career advancement training that ensure an adequate supply of high-skilled trades persons with commitment to the industry engendered by substantial career opportunities. The viability of these structures - as well as individual careers - could be at jeopardy with even more permissive worker classification standards.

Misclassification of employees as independent contractors is in fact epidemic in the construction industry and is a severe threat to degrade the quality of the workforce and service even in the union sector, spreading beyond the low-skill, open-shop segments of the market where the abuses were formerly concentrated.

The construction industry as a whole surpassed even the finance, insurance, and real estate industry, with rates of worker misclassification at 19.8% and 19.3% respectively, according to be 1991 Treasury Department study cited in the Coopers and Lybrand study commissioned by the Coalition for Fair Worker Classification in 1994. (Coopers & Lybrand, *Projection of the Loss in Federal Tax Revenues Due to Misclassification of Workers*, Coalition for Fair Worker Classification, June 1994, page 8.)

Nevertheless, we acknowledge that there can be some legitimate classification of production and skilled craft workers in construction as well as clerical, administrative and professional workers as independent contractors. And we are proud to note, along with our colleagues in the building trades, that the opportunities for career progression from skilled production jobs into supervisory, management, and even business ownership and entrepreneurship are unrivaled in construction as compared with virtually all other manufacturing and goods-producing industries.

However, the epidemic rise of worker misclassification in construction has nothing to do with career enhancement, but rather everything to do with unfair low-wage competition. Our industry can ill afford declining skills and abilities at a time when our product and services are expanding in complexity and sophistication. In fact, the effect of unfair competition by firms that misclassify employees and avoid the payment of employment taxes and other requirements of employment law threatens the maintenance of workforce standards.

Allow flexible criteria by industry to stem abuses

While perhaps well-intentioned, neither H.R. 1972 nor H.R. 482 will stem the tide of workforce degradation brought on by worker misclassification. Unfortunately, either may have the unintended effect of being even more permissive toward abusive practices. While we do not contend that the current IRS standards for judging employment control and direction - along with the flexible 20 common law factors - are either a model of clarity or blueprint for consistency; we nevertheless point out that they have the virtue of established use. The classification standards are at least known, and their impact on encouraging abuse may be far less than the broad leeway and excuse from liability permitted under Section 530.

Unfortunately, both proposals suffer from the same defect - that is, they attempt to legislate, with a complex list of conjunctive and disjunctive factors, a formulaic approach to a highly fact-specific inquiry. Moreover, a legislative approach is static.

We submit that a flexible regulatory approach would be more effective. The draft IRS Training Manual, *Employee or Independent Contractor?*, demonstrates a more flexible approach that would remain adaptable. The IRS manual addresses the fact-specific "control factors under the common-law standard that may indicate the existence of an independent contract or an employee relationship" and "emphasizes that factors may change over time because business relationships and the work environment change over time." (IRS Manual, page 1-1).

Encourage full compliance with employment standards

Both H.R. 1972 and H.R. 582, as legislative standards, are too static to meet the changing workplace practices. Rather, we support IRS efforts to craft appropriate market segment understandings to reflect current industry practices in a more flexible way. Under either legislative proposal, whether the criteria are profit/loss, separate place of business, different clients, or commission payments, taken together they would be too permissive as applied to the construction trade workforce, the unique character of which is not reflected in the law.

Likewise, judgments that turn on investment in training or tools and equipment would encourage misclassification of highly trained, self-equipped construction workers. Similarly, any requirement of a qualifying agreement memorializing the classification could too easily become a unilaterally imposed contract in cases where individuals are without bargaining representation.

In summary, the criteria laid out so far, as applied to a highly trained construction workforce that meets fluctuating market demand from referrals to several projects over a year, could well force a radical transformation of the employment relationships in the construction industry to the detriment of the training and benefits structures that are based on contributions for hours worked under covered employment. Moreover, all the other important legal protections that flow from employment status, including prevailing wage, workers compensation, EEO, family and medical leave, and other labor and employment protections would be jeopardized as well.

In conclusion, MCAA would urge the committee to avoid codification of classification criteria, which perforce would be too broad to meet specific industry conditions, and encourage administrative efforts to continue market segment development of specific industry criteria. Instead, Congress should narrow the liability excuses permitted under Section 530, encourage remedial employment classifications, and increase reporting and filing requirements to achieve greater taxpayer compliance.

MCAA member firms appreciate the Subcommittee's invitation to participate in the hearings. Our association will continue to work with Congress on this most important workforce issue.

STATEMENT OF THE NATIONAL ASSOCIATION OF HOME BUILDERS

Madam Chairwoman and Members of the Subcommittee:

The National Association of Home Builders (NAHB) and its 185,000 members congratulate you for holding this hearing and appreciate the opportunity to present its views. This statement will address the current issues relating to classification of subcontractors as independent contractors in the home construction and remodeling industry.

At the outset, it has long been the position of NAHB that the current law pertaining to worker classification recognizes the unique characteristics of the home building business and allows the flexibility necessary for building industry workers to function in a changing economy. Moreover, the current rules under Section 530 of the Revenue Act of 1978 provide equitable relief for taxpayers who become involved in disputes with respect to worker reclassification.

It has been our concern that a rigid application of static rules regarding the classification of workers would result in the improper classification of legitimate independent subcontractors as employees, and thereby unfairly burden both small businesses and workers.

In this regard, there have been few legislative proposals which address this concern. H.R. 1972, introduced by Representative Jon Christensen would establish reasonable guidelines for the protection of independent contractor status for the home construction and remodeling industry. H.R. 1972 would replace the common law test of employment status with a more objective three-part test but would not repeal Section 530 of the Revenue Act of 1978. It would prohibit the Internal Revenue Service from classifying subcontractors as employees if certain requirements are met. Should a taxpayer fail to maintain active compliance with Internal Revenue Code filing requirements, the taxpayer would than lose the protection of the statute. For the reasons set out below, NAHB supports H.R. 1972.

By contrast, H.R. 582, introduced by Representative Jay Kim, would repeal the safe harbor rule of Section 530 and establish a "modified" rule, which NAHB opposes, as explained more fully below.

INDUSTRY PROFILE

The industry, building single family housing, is comprised mostly of small businessmen and women. Over 50 percent of NAHB members build less than 10 houses per year. Approximately 20 percent build more than 25 houses per year and less than 2 percent of the builders build over 500 houses per year. The single family home building business is clearly comprised of small businesses in virtually every community in the country.

Because the construction of a home entails the transportation to a job site of a wide variety of different materials which are assembled and/or fabricated by a host of different trades, and because job sites necessarily change as the homes are built, the relationship between the home builder and the person who performs the different trades varies widely. The construction of single family homes is basically the coordination of the work of as many as 18 different subcontractors. Another complicating factor, principally in the view of the Internal Revenue Service, is the fact that a home builder routinely does "sub-out"- that is, hire an independent contractor to perform services which may appear to the IRS to constitute performance of "common labor". In those instances, the IRS often alleges that the person is an employee rather than an independent contractor.

Since the volume of work in the home building industry is very unpredictable and seasonal, there is a strong necessity for the business owners to match labor to business needs and not to be encumbered by large permanent payrolls. In today's market, two out of three builder firms are organized as corporations and about one-fourth are sole proprietorships.

	NAHB's Builder Membership	Census of Construction: 1992	
Corporations	64 % Subchapter S 35 % Regular C Corps 29 %	57%	
Partnerships	5%	5%	
Sole Proprietorships	29 %	38%	
Other	1%	1%	

During the last ten years, more builders have been organizing as Subchapter S corporations, so that they can combine limited liability with taxation on only individual earnings.

A builder's organizational structure tends to depend on the size of the business. About 25 percent of small-volume builders are sole proprietorships, whereas only 5 percent of the medium-volume builders and 2% of the large volume builders choose to operate under that structure. The average remodeling firm has one office employee on payroll and operates in one or two counties. Approximately half of the remodeling firms are corporations, while 42 percent are sole proprietorships.

LAND DEVELOPMENT

Home builders vary considerably in the degree to which they directly perform the operations it takes to develop land and build and market homes. According to NAHB's 1996 builder survey, less than half of all builders buy the raw land, install the infra-structure, construct the units, and then sell the product. Over half buy lots from other builders or developers, use subcontractors for all the construction work, and sell through real estate agents.

The difficulty builders have recently experienced obtaining financing for property acquisition and development may result in land development becoming more heavily concentrated among large firms. Moreover, more stringent requirements for loans from financial institutions could mean that builders will look more often to land developers to provide financing for purchases of developed lots. Increasing fees and regulation may also cause land development to become more concentrated among well-financed specialists.

ROLE OF SUBCONTRACTORS

During the past 30 years, the role of subcontractors and professional specialists in the home building industry has increased significantly. Most builders believe that the trend toward increased use of subcontractors will continue. Framing, roofing, bricklaying, foundations, and masonry are generally done by the subcontractors on a labor-only basis, with materials provided by the builder. Other jobs, such as flooring, insulation, and painting, involve subcontracts for both labor and material.

The home building industry (as well as the non-residential construction industry) is characterized by extensive subcontracting of the actual construction work. In 1959, 31 percent of NAHB survey respondents subcontracted three-quarters or more of their construction costs. This figure increased to 63 percent by 1993. Over the same period, the share of builders subcontracting one-quarter or less of their construction costs declined from 19 percent to 6 percent. Large-volume builders tend to subcontract a larger share of the construction cost.

Share of construction cost subcontracted:

Large Builders	86%
Medium Builders	81%
Small Builders	56%

NAHB's 1994 Survey of Builders indicated that subcontractors were the most relied upon source from which to obtain materials and equipment. The survey showed that the majority of general contractors (those that build for a fee on someone else's land) and merchant builders (those that build on land they own and offer the house and land for sale together) subcontracted more than 75 percent of the total construction cost. Larger builders subcontracted an even larger share than small builders. The 1994 Census of Construction indicated that residential builders subcontracted \$36.6 billion, or 49 percent of the value of their hard cost. An earlier study by the Bureau of Labor Statistics found that construction of the typical home involves about 18 different subcontractor firms.

The 1989 NAHB remodelers survey showed that remodelers heavily rely on subcontractors. Ninety-three percent of the remodelers used subcontractors during 1988. Twenty-five percent attributed 50 to 99 percent of their dollar volume to work done by subcontractors and 5 percent subcontracted 100 percent of their dollar volume. The survey also suggested that the usage of subcontractors, rather than hiring of employees, was market, as opposed to tax, driven.

From the worker's point of view, a worker with a skill can generally earn more as a contractor working for a variety of customers than he could on straight salary working for a single employer. The worker may also take pride in being independent of a boss supervising the details of his work.

The primary reason for the extensive use of subcontractors is the episodic, uneven nature of construction and the fact that a particular type of specialist is only needed for a short period during the construction process. Moreover, the general contractor does not have either the expertise or the capacity to oversee and manage the activities of each specialist, monitoring the number of hours worked and purchasing all the materials. So the general contractor issues a subcontract based on negotiation or competitive bids and leaves it to the subcontractor to figure out how to accomplish the work, with the subcontractor often responsible for supplying the necessary building materials.

In 1992, there were 1.5 million establishments characterized by the Census of Construction as "special trade contractors" working as subcontractors to residential and non-residential builders, as well as serving consumers and non-construction firms directly. Establishments with payrolls, of which there were 367,000, had total receipts of \$220 billion, while the 1.10 million establishments with no payroll had receipts of \$25 billion. Out of total receipts, about 36 percent went toward the purchase of materials and supplies and another 8 percent was subcontracted to other subcontractor firms.

Although subcontract work may be subject to competitive bids, most builders develop long-term relationships with their subcontractors, just as consumers tend to patronize the same doctors, dentists, or lawn care firms. Even in long-term relationships and where the subcontractor has no employees, however, the relationship between general contractor and sub is different than that between employer and employee. The builder is not obligated to provide continuing employment for the sub and the sub remains liable to the builder for performance in ways an employee generally is not. There are a variety of other distinctions, many of which are reflected in the common-law tests currently used to distinguish independent contractors from employees.

Construction of a single family home involves about 1,000 hours of on-site labor, and since it takes an average of about six months to complete a house, that is equivalent to one full-time worker. Those 1,000 hours, however, may be performed by as many as 100 different workers, most of whom are proprietors or employees of subcontractor firms. Even if a general contractor knew who all the workers were and how much of the payment to subcontractors was for labor, it would be an overwhelming burden for a builder to account for tax withholding for the army of workers involved in building a home.

CONSEQUENCES OF CLASSIFICATION

Reclassification of subcontractors as employees would:

- 1. Add substantially to the cost of doing business of the small home builder;
- Remove the flexibility of the owner to respond to a volatile market and seasonal conditions:
- Shift the nature of the home building business from small business to a concentration of large firms; and
- Add substantially to the cost of housing driving thousands of projected buyers out of the market.

SECTION 530 OF THE REVENUE ACT OF 1978

Congress enacted §530 of the Revenue Act of 1978 to provide relief to taxpayers involved in tax controversies. This Act provides generally that if a business: (1) did not treat an individual as an employee for any period; (2) filed all tax returns (including Forms 1099) on a basis consistent with its tax position; and (3) has a "reasonable basis" for treating the worker as an independent contractor, the government is not to raise the employment tax issue in an examination.

A reasonable basis that is acceptable under §530 includes having a case or ruling that supports the taxpayer's position, a previous IRS audit in which the independent contractor treatment resulted in no assessment, or a long-standing industry practice.

When a "safe haven" under §530 is found, a company is not a) subject to back taxes or penalties, b) obligated in the future to withhold income taxes from contractor payments nor c) obligated to pay employment taxes on independent contractors.

THE INDEPENDENT CONTRACTOR SIMPLIFICATION ACT, H.R. 1972

Under H.R. 1972, introduced by Representative Jon Christensen (R-NE), in order to be classified as an independent contractor, the subcontractor must satisfy three tests.

To pass the first test, the subcontractor must satisfy one of the following:

- (1) Have a significant investment in assets and/or training;
- (2) Incur significant unreimbursed expenses;
- (3) Agree to work for a specific time or complete a specific result, and be liable for damages for failure to perform;
- (4) Be paid on a commission basis; or
- (5) Purchase a product for resale.

The second test requires that the subcontractor satisfy any one of the following:

- (1) Have a principal place of business;
- (2) Show that he/she does not primarily provide the service in the service recipient's place of business;
- (3) Pay a fair market rent for use of the service recipient's place of business; or
- (4) Show that he/she is not required to perform service exclusively for the service recipient, and
 - a) has performed a significant amount of service for other persons;
 - b) has offered to perform the service for other persons through advertising, individual written or oral solicitations, listing with agencies, brokers and other referral services; or
 - c) provides service under a registered business name.

To satisfy the third test, there must be a written contract between the parties, specifying that the subcontractor is not an employee. In order to retain the protection of the statute, the service recipient must properly file all Forms 1099 or W-2. Should the subcontractor fail to file the required returns, the protection of the statute would be lost.

This legislation would protect construction industry subcontractors from misclassification as employees through the establishment of clear, easily understood, tests. Moreover, H.R. 1972 would not erode the protection of the safe harbor provisions of Section 530 of the Revenue Act of 1978.

THE INDEPENDENT CONTRACTOR TAX FAIRNESS ACT, H.R. 582

H.R. 582, introduced by Representative Jay Kim (R-CA) would repeal Section 530 of the Revenue Act of 1978 and incorporate a modified version of the safe harbor provision into the Internal Revenue Code. Under H.R. 582, in order to be classified as an independent contractor, a subcontractor must perform services pursuant to a written contract and must (a) be able to realize a profit or loss from the services, (b) maintain a separate place of business and have a significant investment in tools or facilities, c) make his or her services available to the general public on a regular and consistent basis and must have performed such services as a subcontractor for another service-recipient during the last two years, or (d) be paid exclusively on a commission basis and maintain a separate principal place of business (or pay fair market rent if not a separate place of business).

The written contract must state that the subcontractor will not be treated as an employee by the contractor, that the contractor is aware of the Federal tax obligations resulting from such treatment and that he/she will maintain separate accounting of income and expenses relating to the contract. If the tests are satisfied, the bill would generally relieve the contractor of employment tax liability. It would increase the penalty for failure to file Forms 1099 and require that independent contractors report each individual 1099 payment received on their income tax returns. H.R. 582 would also direct the Secretary of the Treasury to report to Congress proposing legislation which specifies objectively measurable criteria for determining whether an individual is an employee.

NAHB opposes the proposals to repeal Section 530 of the Revenue Act of 1978 and to delegate legislative authority to the Secretary of the Treasury. We note that Congress enacted Section 530 as the result of over zealous enforcement by the IRS of employment tax laws. Given the propensity of government to classify subcontractors as employees rather than independent contractors, we believe that any legislative proposal in this area must and should be generated by Congress.

Finally, NAHB fully supports the proposition that every American must pay his full share of Federal income tax. Independent contractors employed in the home construction industry generally satisfy the current 20-factor test. Increased IRS compliance activity would unveil dishonest construction contractors and level the playing field for honest construction employers. It is the job of the Internal Revenue Service to resolve the compliance problems in a fair and equitable manner. Improved compliance should be achieved through increasing business's compliance with the reporting requirements. In this regard, NAHB agrees with the proposals to increase IRS enforcement efforts by increasing penalties for failure to file correct payee statements.

CONCLUSION

For the reasons set out above, NAHB supports H.R. 1972 as providing reasonable criteria to establish employment status without restricting the classification of independent contractor. NAHB opposes H.R. 582 as unduly limiting the available safe-harbor protection afforded by Section 530, although we would support increased penalties for noncompliance with the employment tax form filing requirements.

The National Association of Home Builders is much appreciative of having had this opportunity to present our views on the issues relating to classification of home and remodeling industry subcontractors as independent contractors.

NATIONAL ASSOCIATION OF THE REMODELING INDUSTRY 4301 North Fairfax Drive, Suite 310 Arlington, Virginia 22203-1627 703 276-7600 Fax: 703 243-3465

Statement of

Patti Burgio, Director of Government Affairs National Association of the Remodeling Industry submitted to the Oversight Subcommittee of the HouseWays and Means Committee regarding the Status of Independent Contractors June 4, 1996



On behalf of the 6,000 member companies of the National Association of the Remodeling Industry (NARI), representing more than 40,000 home improvement professionals, I am pleased to submit testimony in support of Congressman Jon Christensen's bill, H.R.1972, the Independent Contractor Tax Simplification Act.

The status of independent contractors has been the number concern one for NARI since 1978. It is now the number one issue for the 1995 White House Conference on Small Business. We are pleased the Chairwoman has seen fit to hold these hearings, drawing greater attention to this most important small business issue.

Independent contractors are an integral part of the home improvement industry. Small business general contractors, many of whom started out as independent contractors, commonly contract with specialty craftsmen to fulfill specific aspects of a larger home improvement project. Since each remodeling project is unique, especially for full service remodeling firms, various specialty trades are needed from one job to the next. Independent contractors or subcontractors are well suited to serve in these cases. They provide general contractors with flexibility and cost efficiency in offering varied multi-service projects to the homeowner. They allow remodeling firms to meet fluctuating service demands created by short term projects and specific client needs.

For years, remodelers have struggled with the ambiguities surrounding the definition of an independent contractor. Remodeling firms have suffered financially due to the broad discretion afforded IRS agents in applying the 20 question, common law tests. Despite the Congressional moratorium issued in 1978, the IRS continues to aggressively audit and reclassify subcontractors as employees for federal tax purposes. It is obvious that a bias exists in favoring employee status rather than allowing entrepreneurs to remain in business for themselves.

The ramifications of a reclassification go far beyond federal withholding, unemployment, Social Security and Medicare payments. Besides back taxes, penalties and interest, remodelers are often held liable for state employment taxes, workers' compensation insurance, pension plan payments, and other employee benefits. An IRS or state employment audit often results in the unfortunate dissolution of the company.

The time is now for Congress to enact a clear, fair and objective standard that puts an end to the confusion once and for all. H.R.1972 provides the answer. This is a simple test that anyone can understand. There will be no question as to who is and who is not an employee for federal and state tax and employee benefit purposes.

We have testified in the past in support of such a solution. NARI member, Wayne Kaufman of United Homecraft in St. Louis, Missouri, testified in January 1995 before the House Small Business Committee that this issue was of primary concern to himself and his colleagues in Missouri. Mr. Kaufman is truly representative of most remodeling firms in America.

We are extremely pleased Congressman Christensen and more than two hundred of his colleagues have found a solution to the problem. We believe H.R.1972 is a workable bill that will provide clarity to thousands of general contractors and independent contractors. Many of the inconsistent findings and industry mistakes are made because the existing rules are so vague. This bill spells out the requirements for independent contractors and provides the greatest opportunity for entrepreneurial growth.

Subcontractors are a very independent breed. They prefer to pick and choose which projects they would like to work on. They want to be their own boss. They do not want to be employees; that is why they have struck out on their own. This bill allows that maverick spirit to flourish, creating new companies and new jobs.

Given the recommendation of the White House Conference on Small Business and the new Congressional climate, the time is ripe for Congress to tackle this issue head on and provide small businesses and the IRS with clear guidance that will allow us to easily determine who is and who is not an employee. The first step is to enact H.R.1972.

Second, the focus of the IRS must change to matching Forms 1099 with the actual income reported by independent contractors rather than reclassifying workers. If the subcontractors are under reporting their income, then the IRS should go after them.

Finally, compliance should be enforced consistently. It seems that the IRS likes to set an example in a community by aggressively penalizing one company, the news of which spreads like a wildfire, in hopes that other similar companies will be frightened into hiring their

subcontractors as employees. All subcontractors should not be reclassified as employees simply to benefit the IRS in revenue collections or the Administration in providing employee benefits.

We appreciate the concern of this Subcommittee and truly hope that action is taken soon to clarify the rules regarding the definition of independent contractors. It is extremely difficult for small remodeling firms to continue to operate under such a cloud of uncertainty. Enactment of H.R.1972 will go a long way in clearing the air.

NARI is a not-for-profit trade association with nearly 6.000 member companies nationwide, representing more than 40,000 remodeling industry professionals. NARI members are primarily residential home improvement contractors, and include national manufacturers and distributors of home improvement products and services.

Residential remodeling constitutes a \$100 billion industry that has grown more than 130 percent in the last ten years. With more than 50 years of experience, NARI is committed to enhancing the professionalism of the remodeling industry and serving as an ally to homeowners. NARI is dedicated to the growth and betterment of the remodeling industry and related small businesses. For more information about NARI, contact Patti Burgio, director of government affairs, NARI, 4301 North Fairfax Drive, Suite 310, Arlington, VA 22203, 703/276-7600, ext. 3014.

STATEMENT OF THE NATIONAL CLUB ASSOCIATION

The National Club Association (NCA) submits these comments for the record on the issue of worker classification and H.R. 1972, The Independent Contractor Tax Simplification Act of 1995. NCA is the trade association representing the legal, legislative and business interests of private social, recreational and athletic clubs. Member organizations include country, golf, city, yacht, tennis, and athletic clubs.

The scope of these clubs ranges from small clubs with limited membership and facilities to larger, full-scale operations with dining and extensive recreational facilities. Some clubs are operated on a seasonal basis while many are open year round.

Overview of the Issue

For many years, there has been a lack of clear definition and explicit guidelines for determining the status of workers as employees or independent contractors. Because of the uncertainty of the law in this area, many businesses have in good faith attempted to classify workers properly, only to be challenged by a zealous and determined Internal Revenue Service (IRS) agent. This issue has become critical for many businesses because of the increasingly aggressive employment tax audits used by the IRS. Many small businesses simply do not have the resources or time to properly defend and litigate adverse IRS determinations.

At issue for clubs, particularly golf and country clubs, is how the IRS views workers such as caddies, golf professionals, tennis professionals and musicians. In a recent survey of our member golf clubs all but one club classified caddies as independent contractors. Many of these workers--caddies in particular--have maintained independent contractor status through a long tradition.

Caddies have in fact been an essential part of the game of golf since the first golf club was formed in Scotland in 1746. Today the close relationship between caddie and golfer remains unique in sport.

The number of caddies at each particular club varies, depending on the number of rounds played and whether golf carts are also available. Some clubs use caddies exclusively. Most of the country's caddie programs tend to be located in the Midwest and Northeast. These areas have an advantage over other parts of the country because of a strong tradition of caddies and a golf season that coincides with the school year, making it easy for teenagers to caddie. Caddie programs provide an outstanding work ethic for young men and women who often are working at their first job.

If clubs are required to make caddies "employees" of the club, the financial and administrative liabilities (such as increased recordkeeping, payroll and benefits costs) would be prohibitive, and many fine caddie programs would cease to exist. As a result, many young men and women would lose valuable first-time job opportunities and would become jobless.

Other Ramifications

There are a number of student scholarship programs that exist today solely because of caddie programs. The Evans Scholarship program, established in 1930, is the largest such program in existence and is the largest individually funded scholarship program. More than 480 golf clubs, 125,000 golfers and 22 affiliated golf associations support the Evans program, which has an annual budget of nearly \$5 million and now has over 6,300 alumni. Many other state and local golf associations and individual country clubs also sponsor caddie scholarship programs. The combined financial contributions made to these programs total in the millions each year. If the IRS continues on its course to reclassify caddies as employees many caddie programs would disappear, along with the successful scholarship programs that have enabled thousands of students the opportunity to attend college.

Efforts by the Industry to Address Proper Employee Classification

For many years, NCA has followed independent contractor issues and related compliance requirements. We have produced numerous reference materials and articles to help our members understand the infamous 20-factor test the IRS currently uses. In addition, we have periodically met with IRS officials to obtain information on how our clubs can maintain proper worker classification, especially for caddies.

We have focused particular attention on the ways caddies should be handled. For example, the way a golf club assigns, pays and supervises caddies can determine whether caddies are classified as employees or independent contractors. Because a caddie will rarely have any significant business or financial risk in connection with his or her activities, the factors relating to the control and direction of caddie activities are of greater importance. It has become increasingly difficult to advise clubs in this area however because the interpretations IRS agents apply to various matters under the 20-factor law test have become highly subjective.

Support for H.R. 1972

Worker classification rules needs to be changed and simplified. The current 20-point test used to determine the employment tax status of a worker is vague and subject to various conflicting interpretations. Because of its obfuscatory nature it often precludes a factual determination of a worker's classification. In addition, the IRS often ignores the existing Section 530 safe harbor provisions.

We support H.R. 1972, The Independent Contractor Tax Simplification Act of 1995. The legislation is also supported by The Coalition to Preserve Caddie Programs which is composed of state and regional golf associations and a number of caddie scholarship programs (see Appendix A). The legislation presents an easy, equitable and straightforward set of rules for determining worker classification. Further, it does not seek wholesale changes in the workplace and employment environment, but rather creates a fair basis for determining worker classification. At the same time it supports compliance and reporting efforts so that all workers, despite their classification, pay their fair share of taxes.

One Club's Experience with Worker Classification

Last year, a private golf and country club located in New York state was assessed a significant payroll tax liability by the IRS and was informed that the golf caddles at the club must be classified as employees. The club has appealed the determination which is based on a host of inaccuracies, misrepresentations and unsound conclusions by the IRS as outlined below. This example is provided as a case study, because it clearly illustrates the problems endemic with the 20-factor test.

Among the erroneous conclusions the IRS reached in the New York case is the determination that an employment relationship exists between the caddle and the club, based on an interpretation that the golfer is acting as an "agent" of the club. The IRS concluded that since the club's members are also owner-shareholders of the club, they were acting as agents for the club in making payments to the caddles. Accordingly, the caddles were deemed by the IRS to be under the control of the club and, therefore, employees.

This line of reasoning not only seems absurd, it also fails to take into account several important points. To begin with, not all members of the club are shareholders--only resident members have certificates of membership. Secondly, there is no factual basis to imply that an agency relationship exists between the club and its members.

The IRS took several other unusual positions in this case:

(1) The IRS virtually disregarded club practices concerning caddies and the fact that the caddies receive no remuneration unless they perform services for a member or guest of a member. Remuneration for caddie services is paid to the caddie by the playing member directly. No work schedules are set by the club. Caddies report when they want to earn money, with no reward or sanction for working any particular hours. The club has no obligation to pay the caddies and does not pay caddies. The club neither enforces the payment, determines the amount to be paid or reconciles disputes. Finally, the club gives caddies no instruction, direction or advice on how to carry out their duties.

- (2) The IRS cited provisions of the New York State Disability Benefits Law which requires that clubs cover caddies under their Workers' Compensation Insurance. From this, the IRS concluded, "If they are employees under part of the laws that govern employees, and are not employees, why are they not under all the parts of the (germane) laws?" In fact, the New York State Disability Benefits Law specifically states that the services of golf caddies are not deemed to be employeent. The Workers Compensation Law is also careful to separate caddies from regular club employees, simply stipulating that caddies should be covered as a matter of public policy.
- (3) The IRS totally disregards the fact that Revenue Ruling 69-26 (1969) had established that payment of caddies through a voucher system (members signing for their charges to be made against their club account) does not mean caddies are employees. Since the club does not permit members to sign for caddies, requiring them to pay with cash, the IRS concluded that the club is in violation of its own rules, which require all members to sign for club services. As a result, in an inconceivable stretch of logic, the IRS, determined that the club does not qualify under the revenue ruling. In fact, however, caddie fees cannot be charged to the club because they are not a service supplied by the club.
- (4) The IRS also cited material from a booklet for caddies that is published by a regional golf association and made available to caddies and members of the association. The booklet contains well-established rules of golf, etiquette and safety on a golf course. Although the club neither published the booklet, contributed to the text, or established any of the rules or safety procedures contained within, the IRS incorrectly referred to the booklet as the "club's handbook" and cited it as evidence of training conducted by the club for caddies.

This club does not train caddies. It merely provides a handbook produced by a regional golf association. The IRS reasoned that caddies who follow the booklet must be employees of the club. This is tantamount to saying that a taxpayer's representative who follows Treasury Circular 230, Practice Before the Internal Revenue Service, must be an employee of the IRS. Neither conclusion follows from the facts.

- (5) The IRS also apparently ignored Section 530 relief which serves as a safeguard to protect a business from reclassification of independent contractor as employees, if certain conditions are met. These conditions are as follows:
 - The club has, since 1977, treated similar workers as independent contractors.
 - The club has filed all required forms (1099) in a manner consistent with the individuals being independent contractors.
 - The club has a "reasonable basis" for treating the individual as independent contractors.

Under current law, a reasonable basis for treating an individual as an independent contractor may include revenue rulings, industry practice, or the fact that the IRS has previously audited the club and not reclassified these individuals as employees.

Conclusion

Our member golf clubs take pride in their contribution to the game of golf, for providing substantial work opportunities within their communities and for close adherence to legal and regulatory requirements. They are careful not to establish employment relationships with sports professionals or local caddie pools by following longstanding and well established industry practices. Despite their best efforts to comply with the existing IRS guidelines for determining employment status, they have often been thwarted by IRS agents anxious to find justification for an employment determination.

The current effort by the IRS to reclassify caddies as employees is without basis. If it continues unchanged, it will substantially reduce--and potentially eliminate--the caddie programs at golf courses throughout the country. This will deny work, mentoring and significant scholarship opportunities for many young men and women. Caddying is truly a unique tradition and a special situation. Based upon the apparent interest of the IRS, its future is dependent on reasonable changes in the laws related to worker classification.

We appreciate the subcommittee's efforts to address the problems associated with worker classification and ask that it report H.R. 1972 to the full Committee for consideration.

Appendix A

The Coalition to Preserve Caddie Programs

American Junior Golf Association Caddie Master Carolinas Golf Association Colorado Golf Association Colorado Women's Golf Assn Georgia State Golf Association Golf Association of Michigan Golf Association of Philadelphia Indiana Junior Golf Association Massachusetts Golf Association Metropolitan Golf Association Minnesota Golf Association New Hampshire Golf Association New York State Golf Association Northern Ohio Golf Association South Dakota Golf Association Southern California Golf Association Southern Texas Golf Association Tarheel Youth Golf Association Toledo District Golf Association Vermont Golf Association Virginia State Golf Association Western Golf Association/Evans Scholars Foundation Wisconsin State Golf Association

STATEMENT OF THE NATIONAL FEDERATION OF INDEPENDENT BUSINESS

INDEPENDENT CONTRACTOR TESTIMONY HOUSE WAYS AND MEANS OVERSIGHT SUBCOMMITTEE

The National Federation of Independent Business (NFIB) appreciates the opportunity to submit testimony on the issue of independent contractors and how they are being impacted by the Internal Revenue Service (IRS) enforcement. NFIB is the nation's largest small business organization representing more than 600,000 small business owners from all fifty states. The typical NFIB member has five employees and has \$350,000 in gross annual sales. NFIB sets its public policy positions through regular polling of the membership.

What is an Independent Contractor?

Independent contractors are men and women who have decided to work for themselves instead of working for an employer. They are found in a wide variety of industries, and they usually control their own hours, work with their own equipment, and are not subject to the direct control of the business owner.

Independent contractors play a very important role in both our economy and our society. An independent contractor is a budding small business. Deciding to work for yourself is the first tentative step toward establishing a business. The United States has a strong tradition in encouraging entrepreneurs and business creation. The decision to strike out on one's own as an independent contractor is often the first step in this process.

Independent contractors also serve a variety of functions that are not easily performed by employees. They allow a small business owner to temporarily hire someone with a skill that is needed by the business for a short period of time or on an occasional basis. It is not unusual for a business to have variety of jobs arise during the year that cannot be handled with the current work force but that do not require hiring an additional employee. By hiring an independent contractor, a business owner can have the job taken care of quickly without having to hire someone that may have to soon be let go. The availability of independent contractors allows small businesses to be more flexible and more competitive.

Imagine that you are a small retailer and you determine that you need to computerize your operations to keep better inventory control and to permit your business to grow. So you contract with a specialist to design the system for you, and you pay the person for the work after the product is delivered.

One or two years later the Internal Revenue Service (IRS) is performing a standard audit and you are asked for the documentation on the work that was done. It is then that the IRS tells you that you failed to treat this individual as an employee and that you should have withheld taxes for social security and income, and that you are going to be penalized 100 percent of the liability and that, if you do not agree, the IRS will place a lien on your bank accounts effective in 60 days without any right to appeal.

You never considered this person an employee, certainly the individual who did the work never considered himself an employee, but because of a vague set of rules, the IRS can come back after the fact and dictate this treatment of that individual.

Thousands of small business owners face this issue every day and yet we wonder why small business owners have no confidence in our tax system. Should we also wonder why the 1995 White House Conference on Small Business considered this the number one small business issue?

This issue has festered long enough and needs to be resolved. NFIB, along with the Small Business Legislative Council, have for the past five years co-chaired a coalition of some

50 organizations who have the common goal of reform of the independent contractor rules.

NFIB has worked with Congressman Christensen and others to support legislation to provide clarity to the independent contractor rules. Congressman Christensen is to be congratulated for realizing the importance of this issue and for the need for action in this area.

Chairwoman Johnson is also to be congratulated for holding these hearings to permit debate of the real issues. NFIB looks forward to working with all members of the committee to resolve this important economic justice issue.

Background

The issue of Independent Contractor Classification has literally vexed Congress, the IRS, and taxpayers for more than twenty years. Current law provides little real guidance to either the IRS or taxpayers with the result being lengthy court actions and many small businesses faced with the threat of bankruptcy from government action. Congress has attempted to address this issue in the past only to find itself faced with a wide array of complex issues raised to address special situations.

The existing safe harbor under Section 530 of the Tax Reform Act of 1978 was made permanent in the Tax Equity and Fiscal Responsibility Act of 1982. However, one need only look at the changes that have taken place in the economy since 1982 to realize that a safe harbor that primarily relied on the existence of a prior audit is useless in an industry that did not exist before 1982.

The growth in small business being attested to this week -- small business week -- provides the clearest reason why the classification rules for independent contractors need to be clarified. The millions of new small businesses owners, and the many millions of more job holders that have resulted, need to know that the purpose of the tax code is to fairly collect taxes, not to destroy jobs and opportunities.

Often it appeared that the IRS, standing alone, sought to prevent the changes in the workforce that were happening in the workplace. Finally, after many years the IRS has publicly stated that it has no interest in whether a taxpayer is an employee or an independent contractor, so long as individuals properly report their taxes.

In addition, small business has no interest in turning every employee into an independent contractor contrary to what many in the labor movement believe. The resolution of this issue must provide the economic freedom for individuals to risk -- risk being the basis for our capitalist economy. Concurrently, this same law cannot be used to force individuals into independent contractor status against their wills or in violation of existing laws.

Legislation

The more than 600,000 members of NFIB support this committee taking action to enact the bill introduced by Congressman Christensen, HR 1972. The legislation introduced by Congressman Christensen goes a long way to resolving the key issue in the independent contractor debate: What are the rules? Once everybody -- taxpayers and the IRS -- knows what the rules are, issues of enforcement can be addressed much more clearly and straightforwardly without the need for unreasonable compliance rules.

HR 1972 provides a clear outline to address the independent contractor issue. The Christensen bill does not permit wholesale reclassification of employees as independent contractors. It is important to note that the new safe harbor provided by this bill could only be available if income is properly reported. The new safe harbor requires the individual to take affirmative and definite steps to prove that he or she is an independent business owner. State employment laws prevent employers from wholesale reclassification and unemployment and workers compensation statutes in most states prevent wholesale abuses.

Christensen Bill, HR 1972

The premise of focusing the solution of the independent contractor debate on underreporting of income, rather than on whether the lines are drawn precisely, is borne from many at the IRS who clearly believe that the IRS has no direct interest in whether an individual is an independent contractor or an employee, so long as the individual accurately is reporting his or her income.

The Christensen legislation seeks to provide the individual with a choice, but a choice that comes with a responsibility. The bill requires a taxpayer to properly report his income to be able to use the <u>additional safe harbor</u> available in HR 1972.

This key factor has been left out of many analyses of HR 1972 and is fundamental to making it work so it bears repeating. HR 1972 simultaneously requires the service provider and service recipient to properly report all income to receive the benefits of the new safe harbor.

This proposal was designed so that both parties would have control. Its purpose is not to permit employers or service recipients to enforce wholesale changes to their workforces. Concurrently, it does provide flexibility to the service recipient. It permits a business with employees performing one function to utilize an outside independent contractor when circumstances warrant, without fear of IRS retaliation.

HR 1972, The IC Tax Simplification Act of 1995

In general, this proposal will substitute a new set of criteria for determining whether an individual is or is not an independent contractor by providing rules on who is <u>not an employee</u>. Current law relies on 20 common law factors that do not permit a factual determination of the individual's status as it is determined on an industry-by-industry basis. In our proposal, the determination is made whether the individual is or is not an employee, if he or she is not an employee, the individual is an independent contractor.

This new criteria may only be used if the independent contractor and the business for whom services are being performed correctly comply with income reporting rules. If the service recipient properly reports all payments for service to the IRS, then the rules may be relied upon. If all payments are not properly reported, neither the independent contractor nor the service recipient may rely upon this new rule, and must base any determination on the existing common law rules and existing case law.

General Rule

If the requirements of Section b, c, d, and e of HR 1972 are met, the service provider will not be considered an employee and both the service recipient and payer will not be considered an employer.

Section (b)

The service provider or independent contractor will satisfy this section's requirements if the individual can exhibit:

- a significant investment in assets and/or training;
- 2. incurring significant unreimbursed expenses;
- 3. agreement to complete a project and is liable for damages and may be terminated without cause;
 - payment on a commission basis;

5. purchasing of products for resale.

This section is intended to demonstrate training and investment in the business whether the investment is in physical assets or intellectual property and training. In addition, if products are purchased for resale or on a commission, the individual is obviously risking his or her own capital and should be considered as in business.

Section (c)

The independent contractor must demonstrate the use of a principal place of business or the service provider must demonstrate the intention to offer his services to others and to be marketing his services on a regular basis. Qualifying in this section illustrates both independence and an investment in an office. In addition, if the individual has gone to the trouble of registering a trade name with the state, it is evidence of independent contractor status.

Section (d)

A written contract must exist stating that the services are being provided and that the person will not be treated as an employee. A written contract that states the responsibilities for paying taxes by both the service recipient and service provider will help to insure compliance and awareness by both parties of their tax obligations.

Section (e)

This section prescribes that if the service recipient fails to meet his obligations to file information reporting returns, they cannot rely upon the protection in this section. They must then rely upon existing law and all of its traps.

Tax Compliance Estimates

As an aside, recently the IRS released a study of compliance between 1985 and 1992. The study reveals a growing tax compliance gap especially in categories where self-employed tax payers are predominant. Troubling as this might be, one must wonder whether there is any correlation between the increase in the tax compliance gap and the overwhelming number of changes made to the Internal Revenue Code over this same time period.

Congress between 1984 and 1992 enacted nearly 10,000 changes to the Internal Revenue Code! Small business owners are among those least able to spend the time to become aware of these changes. Even large firms have increased difficulties with the tax code, and I recall the Chief Financial Office of Mobil Corporation, in testimony before this Committee, exhibiting a pile of papers several feet high as its annual tax return.

This same individual was then asked if he thought the tax return was accurate in all respects, and he was required to give a qualified answer because he knew that some issues were open to various interpretations. Well, if a Fortune 100 company with its army of lawyers and accountants are having trouble, what do you think small business owners are having?

NFIB members are not trying to avoid paying their fair share of taxes, but they want rules that they can understand the implications of and with which they can comply. Compliance gaps will only go down if we begin to move in this direction.

Clearly, the Christensen bill would only work with adequate tax enforcement mechanisms to insure that both service providers and service recipients are properly reporting these items on their tax returns. NFIB would support such efforts so long as they were consistent with realistic reporting rules.

HR 582 -- Legislation Introduced by Congressman Jay Kim

The Kim legislation makes several constructive proposals with regard to the Section 530

safe harbor. Since the Christensen legislation seeks to propose a safe harbor that could be used as an alternative to Section 530, and since many industries have come to rely on Section 530, the Committee may want to look at how 530 works when considering legislation.

Specifically, the Committee will want to consider proposals which address the consistency standard insofar as what is defined as a significant segment of an industry for satisfying Section 530. The proposal in the Kim bill seeks to place a 25 percent threshold on this definition. This issue is important because the IRS seems to believe that at least 95 percent of an industry must be the definition of a significant segment of an industry.

Any threshold must consider whether other factors should be applied, such as regional considerations and urban vs. rural concerns.

White House Conference on Small Business

In June of 1995, the 2,000 small business owners attending the White House Conference on Small Business told IRS Commissioner Richardson, face to face, that the classification issue was of great concern to them. The Conference then proceeded to make the classification issue its number one concern.

Earlier this year, the IRS at long last responded. The IRS offered a major revision to its training manual for IRS employees illustrating how the 20 factors should be utilized in performing a classification audit. Concurrently, the IRS also released a settlement program whereby a taxpayer under audit could settle the case for only a percentage of the current year's liability, provided the taxpayer agreed to treat the individuals whose status was in dispute as employees in the future.

Comments on IRS Training Manual for Determining Employee or Independent Contractor -- Published 2/96

Although an important step forward for the IRS, the manual only serves to illustrate the need for permanent legislation. First, since the manual does not have the force of law or regulations, neither Congress nor taxpayers have the opportunity to comment on what the manual proposes to do. The manual fails to address issues relating to operation of the Section 530 safe harbor and how to interpret the consistency standard in a way that is rational and makes sense.

While the manual states that independent contractor status is a "valid and appropriate business choice", the IRS and Congress have the responsibility of interpreting the law to prevent abuse of individuals. Concurrently, it also has the responsibility to prevent the abuse of other individuals who choose to be independent contractors and self-employed small business owners.

Overview of Training Manual

The manual seeks to dissect the 20 factor rules and provide IRS employees with a more realistic view of the way in which business is done today and the nature of how those relationships have changed. Where the manual falls short is where it fails to give the agents clear guidance on how to weigh and balance the 20 factors in different circumstances other than to tell them that certain factors are irrelevant in specific circumstances.

In many ways the manual makes the case that small business owners have made for years, i.e. that the 20 common law factors are extremely ambiguous and that the application of the 20 common law factors is highly subjective. The second issue where the manual also makes a positive although minor contribution is in the application of the Section 530 safe harbor, even though it fails to completely follow through in this area.

The manual provides that the examining agent must, even if the taxpayer fails to raise the issue, determine whether the Section 530 safe harbor can apply. Yet the guidance then fails to help the agent determine what is a reasonable basis for taking a position and what constitutes an industry practice.

Specific Comments

Interpreting the 20 Factor formula

Control Standards

The Manual on page 1-6 states three preliminary points:

There is no magic number of factors used; the factors merely point to facts to be used in evaluating the extent of the right to direct and control.

As in any examination, all relevant information needs to be explored before answering the legal question of whether the right to direct and control associated with the employment relationship exists.

The evidence that you gather must be factual and well documented and must support your determination; it is not sufficient to state a legal theory.

The subjective nature of the control factors and the interpretations of the control factors can have the result that many of the issues are neutral factors in determining whether the individual is an employee or independent contractor. While the manual is attempting to encourage IRS employees to use their initiative in developing these issues, it also fails to give them direction.

For many years IRS employees have viewed the independent contractor relationship negatively to say the least. Failing to provide a more concrete basis for the IRS employees in their analysis for relevant weighing of factors may result in an examination turning not on 20 factors but in the balance on two or three factors.

Behavioral Control and Financial Control

In the factors listed under behavioral control, the IRS concedes that several issues are indicative of either employee or independent contractor status. The profession or occupation which required prior training and abilities lends itself to being independent of control and indicative of independent contractor status.

Many of the financial control factors can be of neutral importance, or significant relevance, depending on how the taxpayer has built the relationship. Clearly the auditor is warned not to take the taxpayer's word for the relationship evidenced by the discussion about written agreements.

Burden of Proof

The basis for most tax return examinations is that the taxpayer has filed a tax return where it treats an item in a specific way, and the IRS employee is free to question the tax treatment. On the issue of independent contractor status, the burden is on the taxpayer to provide the agent with all relevant information available to the taxpayer and then the burden is on the taxpayer to provide all other relevant information requested.

The IRS is not constrained in what it can ask for and in how much it may ask for as long as the request is relevant to the issue. Under the new manual, the instructions have not changed as much as the interpretations of specific facts. Clearly, the manual does place an increased burden on the IRS to justify a finding of employee status. However, the burden can be even greater on the taxpayer who may never have considered answering all of these questions because it was confident of reliance on the Section 530 safe harbor.

Raising the Section 530 Safe Harbor

The Section 530 safe harbor, made permanent in the 1982 Revenue Act, permits a taxpayer to qualify for use of an independent contractor status based on a consistency test and a reasonable basis test. The proposed audit manual requires the IRS to find that an employee status exists and then to look to Section 530 issues. To many small business owners this may be taking the issue backwards. This new rule places a significantly increased burden on many taxpayers who never considered seeking relief under the 20 factors.

In the Revenue Act of 1978, and then 1982, this issue of whether the taxpayer's relationship must first be deemed employee and employer before the safe harbor can apply never is raised. The proposed manual makes this a requirement that the IRS first find that an employee relationship exists and then look to Section 530. We believe that this should be changed to provide the taxpayer an opportunity to rely on Section 530 immediately after the IRS raises the issue of employee status.

Reasonable Basis Test and Industry Practice

Another concern over the 530 safe harbor is that, after extensive analysis of the 20 factor rules, it provides the agent with little guidance on the reasonable basis test regarding industry practice.

The safe harbor permits an independent contractor relationship to exist if based on long standing industry practice that independent contractor status is a recognized practice of a significant segment of the industry. Many court cases have sought to resolve what is the meaning of "long standing", "significant", and what is "an industry".

This is reminiscent of the <u>Soliman</u> decision on home office deduction where the Supreme Court relied on a dictionary definition or the word "principal" in the phrase "principal place of business". Many small business owners lost out on this definition.

The IRS fails to provide any realistic guidance on how to interpret these factors in the context of a reasonable basis requirement and as many employers rely on the safe harbor, the result will be failure of the test since the IRS has already deemed them an employee.

Recommendations

- o Provide additional guidance on how the factors are to be weighed and the contexts in which the IRS employee may use his initiative to weigh the various factors.
- o Permit the agent to use the 530 safe harbor at the beginning. There is no need to have the agent find that an employment relationship exists, only to have to disprove his own theories about the taxpayer. It goes against human nature.
- Provide more guidance to help the IRS auditor understand the possible reasonable basis standards.
- o Permit the auditor to look to significant segments on a regional and local basis when considering the industry practice standard. Provide guidance that permits a taxpayer to rely on an industry segment which does not comprise more than half of the industry.
- Continue the process of employee education on an annual basis, as business factors are always changing.

This Committee, in addressing the worker classification issue, may wish to consider whether Section 530 should in fact be codified to protect those industries who rely on their status based on Section 530 and who have done so for the last twenty years. In addition, the Committee may wish to consider how to make Section 530 work more efficiently with regards to definitional issues.

Finally, the Committee may wish to consider eliminating rules that prevent some

industries from qualifying under Section 530, such as technical services workers. It would make no sense to have a rule that resolves the issue but which has so targeted a provision that it is unfair to one sector of the economy.

Conclusion

This Subcommittee should consider and report HR 1972 to the full Committee for positive action. Issues of concern to groups or individuals should be addressed so as to prevent the proposal from being abused by anyone. Clearly, the current enforcement pattern has severe difficulties and it is our firm belief that a line and the drawn somewhere so that taxpayers can obey the rules. It is clearly unfair to millions of small business owners and the millions of independent contractors to have this issue remain in limbo any longer.

While the revised audit manual provides better guidance to IRS employees, it does not sufficiently establish what the rules are for all sectors of the economy. The results of the new manual only place a greater burden on whether the Section 530 safe harbor rules provide any relief. Clearly, they need work.

Finally, audit guidance is no replacement for statutory certainty. With all due respect, if new leadership emerged at the IRS, taxpayers would have no recourse to Congress on an audit manual.

Statutory guidance is needed to resolve this issue and NFIB supports efforts to update the existing law by adding the safe harbor included in HR 1972.



STATEMENT OF THE NATIONAL TECHNICAL SERVICES ASSOCIATION BEFORE THE SUBCOMMITTEE ON OVERSIGHT HOUSE COMMITTEE ON WAYS AND MEANS HEARING ON WORKER CLASSIFICATION ISSUES

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I. Introduction: Madam Chairwoman and members of the Subcommittee, thank you for this opportunity to comment on the above-referenced issue and pertinent legislation being considered by you and your colleagues. My name is Robert G. Drummer and I am Director of Government and Public Relations for the National Technical Services Association (NTSA). NTSA's comments are designed to assist you in crafting and passing legislation which will clarify and simplify the distinction between "independent contractors" and "employees" for both tax and employment law purposes. As you analyze Rep. Jon Christensen's bill, H.R. 1972, and any other comparable legislation (i.e., H.R. 582, S. 1610), please consider the following:

II. NTSA Member Concerns

Members have been concerned for some time over the widespread confusion concerning the tax policy standards under which technical services personnel could – reasonably – be classified as independent contractors. When the IRS, applying the common law test, has addressed the issue of worker classification in the technical services industry, the IRS has generally been of the view that the personnel are employees of the technical services firms for purposes of federal income, social security, and unemployment tax withholding.¹

Some firms, especially those with a computer specialty focus, would prefer to classify their personnel as independent contractors. Still other firms would prefer to classify their workers, on a contract by contract basis, as employees or independent contractors.

Members believe that standards for classifying workers as independent contractors or employees should be clear and objective, leaving little doubt as to the outcome of an IRS audit. While NTSA has never advocated a preference for one classification over another, it has repeatedly urged that worker classification standards be applied consistently so that firms and individuals which supply like services in competitive marketplaces are subject to the same set of rules and the same set of outcomes for non-compliance.

Rev. Rul. 87-41, 1987-1 C.B. 296; Rev. Rul. 75-41, 1975-1 C.B. 323; LTR 8552072 (Sept. 30, 1985); LTR 8324005 (technical advice memorandum, Feb. 24, 1983); Ltr 8403003 (technical advice memorandum supplementing LTR 8324005, September 22, 1983).

Unfortunately, employment status determinations currently do not provide for consistent outcomes. Each employment status determination is made on a "facts and circumstances" basis. The 20 factor common law test, which assumes some subjective interpretation on the part of enforcement personnel, often results in conflicting outcomes. Other IRS enforcement activities often result in 1) investigations of employers who have not misclassified their workers; 2) reclassification for certain employers' workers but not their competitors' workers; or 3) no action against employers who are covered under the relief provisions established under § 530 of the Revenue Act of 1978.²

III. Practical Considerations

The application of IRS worker classification standards, whether in their current form, or as may be amended, however, apply only to tax related questions. A worker who may be classified as an independent contractor for tax purposes under any set of standards, may remain an employee under the criteria set forth in the Fair Labor Standards Act, Title VII of the Civil Rights Act, the Americans with Disabilities Act, the Family and Medical Leave Act and various state unemployment and workers' compensation laws. The idea that worker classified as an independent contractor for tax purposes might later successfully challenge a failure to pay premium overtime or make a claim for an uninsured work-related injury is perplexing.³ This anomalous but very real result can only lead to more confusion and inequities.

Following, for example, is a brief listing of liability issues which can result when a worker is misclassified as an independent contractor.

A. Tax and FICA Liabilities

As previously noted, a worker who has been misclassified as an independent contractor is subject to retroactive reclassification as an employee making the technical services firm liable for significant tax and social security payments and penalties. Among them:

- A penalty for failure to withhold income tax from the employee equal to 100% of the amount of the income tax which should have been withheld.⁴
- 2) One hundred percent (100 %) of the income tax itself which should have been paid by the employee unless the employer can prove that the employee paid his full income tax liability. A signed certificate, Form 4669, obtained from the employee, is generally required to meet this burden.⁵
- A penalty equal to 100% of the FICA taxes which should have been withheld from the employee's pay.⁶
- 4) One hundred percent (100%) of the FICA tax itself (employer plus employee share).⁷

United States Committee on Government Operations House Report 101-979, pg. 11 (Nov. 9, 1990).

³ In Robert A. Mitishen v. Otis Elevator Co., et al., 1990 U.S. Dis. LEXIS 12465 (9-19-90) a computer consultant was reclassed as an employee for purposes of workers' compensation coverage in the District of Columbia. In re: TSR Consulting Services, Inc., 1990, N.Y. Appl. Div. LEXIS 13035 (11-1-90) a computer consultant was reclassed as an employee for New York unemployment compensation purposes; See also Rakam, Inc., v. Thomas F. Hartness as Commissioner of Labor, 1990 N. Y. Appl Div. LEXIS 11296 (9-20-90) and Beau v. Commissioner of Jobs and Training, 1991 Minn. App. LEXIS 799, (8-13-91).

⁴ IRC Sec. 3402(a), Sec. 6672.

⁵ IRC Sec. 3403.

⁶ IRC Sec. 6672.

⁷ IRC Sec. 3102(b).

5) In addition, there can be penalties for failure to file a return, negligence penalties, and fraud penalties in the event that it is determined that the employer's misclassification of the worker is fraudulent. Further, these taxes and penalties are collectible from officers, directors or other "responsible persons" acting on behalf of the employer. In extreme cases, criminal penalties may also be assessed.⁹

B. Overtime Payments and Penalties

A worker who has been misclassified as an "independent contractor" may not have been paid overtime in accordance with the Fair Labor Standards Act. Once reclassified as an employee, he becomes subject to this Act and for each week in which he worked over 40 hours he becomes entitled to the following:

- 1) one-half the hourly rate for each such hour worked;
- 2) a liquidated damages amount of up to 100% of this half-time rate;
- attorneys' fees;
- additional FICA and unemployment tax (paid with respect to the employee) based upon the increase in the wages paid to the employees.

The statute of limitations for FLSA violations is 2 years except for willful violations, in which case the statute of limitations is 3 years. In severe cases, the firm may also become subject to criminal penalties.¹⁰

C. Workers' Compensation Liabilities

When a worker is reclassified as an employee, he becomes entitled to claim workers' compensation benefits for injuries incurred on the job. The technical services firm can become liable for payment of workers' compensation benefits regardless of whether appropriate coverage was maintained. The technical services firm can also become subject to fines and its principals subject to imprisonment under state law for failure to have adequately provided workers' compensation coverage for all of its employees.¹¹

D. Unemployment Compensation Liabilities

Companies that retain workers as independent contractors who are subsequently reclassified as employees become liable for unemployment compensation contributions for the employees. As with income taxes, responsible persons (i.e., officers, directors, etc.) of the employer can become personally liable for these amounts.¹²

⁸ IRC Sec. 6651 and IRC Sec. 6653(a)-(b).

⁹ See 22 ALR 3rd 8; See also 51 ALR Fed. 59, Rev. Rul. 67-18, Ltr. Rul. 7905073, and Income Tax Regulations Section 31.3401(c)-1.

¹⁰ See Fair Labor Standards Act, 29 USC 201-219, and 51 ALR Fed. 702.

¹¹ See, for example, The Pennsylvania Workmen's Compensation Act, P.L. 736, as amended, Sections 103, 104, 301, and 305.

¹² Silverman v. Dudley, 244 N.E. 2nd 531; C.A. Wright Pluming Company v. Unemployment Compensation Board of Review, 293 A. 2nd 293.

E. Liability for Personal Injury or Property Damage

When a company retains a genuine independent contractor, the independent contractor generally stands on its own with respect to liability to third parties for its actions. The independent contractor is generally not acting as the representative or agent of the company and the company is not liable for any injury or damage which the independent contract may cause to third parties or their property. However, when a person is reclassified from "independent contractor" to "employee," the employer (i.e., the technical service company) can become liable for the on-the-job acts of the "employee," including personal injuries caused to third parties and property damage caused to property.

IV. Policy Recommendations

Whatever rules are finally adopted by Congress must apply equally to all companies and workers, regardless of how long a company has been in business and regardless of how it has classified its workers in the past. If rules are linked to the age of the company or how it classified workers in the past, the confusion and inequities will simply continue. NTSA continues to support repeal or substantial modification of the relief provisions offered under § 530. NTSA also believes that a limited scope taxpayer amnesty program should be instituted concurrent with the repeal of § 530. In addition, NTSA continues to urge Congress to provide significant guidance by setting forth a limited number of factors which employers, individual taxpayers, and enforcement organizations might use to qualify employment status determinations. These factors should be based on common law and expressed as safe harbors.

NTSA suggests this balance can be achieved by enacting two safe havens – one for independent contractors and one for employees. Each can be developed through the prioritization of common law test elements. Taxpayers who fall within one of these "safe havens" could rest assured that they would not be subjected to large retroactive penalties should their worker classification be questioned upon audit. Likewise, NTSA believes that if a worker's situation is such that he or she disputes the classification, he or she should be able to request a ruling from the IRS based on the broader application of the 20 common law factors, This request would be made through a version of the current Form SS-8 procedure. 13

V. About NTSA

The National Technical Services Association (NTSA) is a non-profit 501(c)(6) organization which exists to promote the legal, legislative, regulatory, strategic business development, and continuous process improvement interests of member firms. Member firms supply a wide range of design, drafting, engineering, project management, computer programming, systems analysis, staff augmentation, and technical publication services, for profit, to industry and government clients. Member firms now number among their clients most major American corporations, thousands of small industrial companies, government agencies, and colleges and universities across the United States. Member firms employ more than 280,000 personnel who possess the training and experience required to meet America's rapidly changing technical requirements.

Robert G. Drummer, Esq.
Director, Government & Public Relations

Respectfully Summitted,

¹³ See "Statement of the National Technical Services Association," Hearing before the Commerce, Consumer, and Monetary Affairs Subcommittee of the Committee on Government Operations House of Representatives, 101st Cong., 1st Sess., June 8, 1993.

WRITTEN TESTIMONY OF THE SECURITIES INDUSTRY ASSOCIATION

SUBCOMMITTEE ON OVERSIGHT COMMITTEE ON WAYS AND MEANS UNITED STATES HOUSE OF REPRESENTATIVES

July 3, 1996

The Securities Industry Association ("SIA") appreciates the opportunity to submit written testimony on the issue of independent contractor status. The SIA brings together the shared interests of about 700 securities firms throughout North America to accomplish common goals. SIA members — including investment banks, broker-dealers, specialists, and mutual fund companies — are active in all markets and in all phases of corporate and public finance. In the United States, SIA members collectively account for approximately 90 percent, or \$100 billion, of securities firms' revenues and employ about 350,000 individuals. They manage the accounts of more than 50 million investors directly and tens of millions of investors indirectly through corporate, thrift, and pension plans.

Our testimony addresses employment classification for U.S. federal income tax purposes of service providers in the securities industry. Under current law, a subjective "20 factor" common law test is applied to determine how a worker will be classified for tax purposes. Under the "control" factor, if the worker is required to comply with instructions given by the service recipient about when, where, and how to work, the worker is generally considered to be an employee rather than an independent contractor.

In the securities industry, as in other regulated industries, government regulatory agencies and self regulatory bodies, such as the National Association of Securities Dealers ("NASD"), tell securities firms and the "registered representatives" associated with these firms how certain aspects of the work are to be done and how they may not be done. Indeed, such agencies impose upon the securities firms a "duty to supervise" the registered representatives to ensure that these regulatory requirements are satisfied. In such an industry, the "duty to supervise" must be distinguished from the "right to control" in applying the 20 factor common law test to determine employment classification. The Internal Revenue Service ("IRS"), however, does not generally recognize this critical distinction. Accordingly, we respectfully urge Congress to clarify that actions undertaken by a business to satisfy a "duty to supervise" to ensure compliance with regulatory requirements in a regulated industry are not indicative of either employment or independent contractor status.

A. The Duty to Supervise in a Regulated Business

If the service recipient is a business in a regulated industry, such as the securities industry, the worker should not be deemed to be an employee if the business implements policies and procedures necessary to ensure compliance with regulatory requirements imposed on it by government agencies.

A business in a regulated industry must insure that its workers meet the requirements and standards set by the regulatory agencies. By implementing policies and procedures of the regulatory agencies to insure such compliance, the business is merely acting as an agent of the government agency. Any behavioral controls that the business imposes on the worker through these policies and procedures are designed to foster the regulatory goals of the government or self-regulatory agency and comply with applicable laws, not to enhance the benefits or profits that may flow to the business as a result of the workers' performance. Accordingly, if a business is required by regulatory agencies to supervise the activities of its workers to insure the workers' activities are in compliance with the regulatory agencies' rules and regulations, such supervision should not be indicative of either employee or independent contractor status.

Specifically, in the securities industry the law requires that a "registered representative" who is engaged in the investment banking or securities business must be associated with a broker/dealer. Some registered representatives spend their entire workday attempting to generate

commission income for themselves and for the benefit of the broker/dealer. Other registered representatives operate their own businesses, which may consist solely of selling securities, or may also include financial planning, investment advisory services, insurance brokerage, estate planning, business consulting, accounting, tax preparation, etc. Such registered representatives operate as separate entrepreneurs and may have employees of their own. In both situations, the registered representative, as well as the broker/dealer with which he or she is associated, is subject to the rules and regulations of the Securities Act of 1933, the Securities and Exchange Act of 1934, and the rules of self regulatory organizations such as the NASD. Under these rules, a broker/dealer does not have the right to control a registered representative associated with it; rather such a broker/dealer has the duty to supervise the registered representative with respect to his or her adherence to the regulations of the Securities and Exchange Commission and the NASD. Indeed, a registered representative may be subject to disciplinary action by the NASD on the basis of customer complaints. Such authority vested in the NASD rather than with the associated broker/dealer.

B. Judicial Interpretation of "Control" Factor

Case law supports the view that compliance with government regulation does not indicate "control" by the broker dealer. Courts have repeatedly stated that compliance should be a non-factor in the worker classification determination.

Inc. v. NLRB², the court rejected the significance of the company's compliance with the government restrictions in determining worker classification:

[R]estrictions upon a worker's manner and means of performance that spring from government regulation (rather than company initiatives) do not necessarily support a conclusion of employment status. See, e.g., Local 777. Democratic Union Org. Comm., Seafarers Int'l Union v. NLRB, 603 F.2d 862, 875-76 (D.C. Cir. 1978). Indeed, employer efforts to ensure the worker's compliance with government regulations, even when those efforts restrict the manner and means of performance, do not weigh in favor of employee status. **

Additionally, efforts by a business to ensure compliance with government regulation should not be relevant to the control test. In <u>Yellow Taxi Cab Co. v. NLRB</u>, the airport established a detailed regulatory ordinance prescribing strict procedures for the operation of taxis at the airport, including the maintaining of "trip sheets." The court held that the compliance measures requiring the preparation of reports were not important in the determination of worker status. The D.C. Circuit stressed that "[c]ourts have consistently held that regulation imposed by government authorities does not evidence employer control." As this decision indicates, the broker/dealer does not exert control when he or she requires a registered representative to comply with Securities and Exchange Commission regulations by compiling account reports.

Each of these decisions is premised on the fact that service recipient compliance with government regulation does not amount to "control" exerted by the service recipient. Rather, the service recipient is performing its <u>duty to supervise</u> as required by law. Expressing this

See, e.g., Yellow Taxi Cab Co. v. NLRB, 721 F.2d 366 (D.C. Cir. 1983); NLRB
 v. Associated Diamond Cabs. Inc., 702 F.2d 912 (11th Cir. 1983); Air Transit. Inc. v.
 NLRB, 679 F.2d 1095 (4th Cir. 1982).

² 869 F.2d 596 (D.C. Cir. 1989).

^{3/} Id. at 599.

⁴ 721 F.2d 366 (D.C. Cir. 1983).

[§] Id. at 371.

<u>Id</u>. at 374.

view, the court in Local 777, Democratic Union Org. Comm., Seafarers Int'l Union v. NLRB^{1/2} rejected the National Labor Relations Board's ("NLRB's") decision that compliance evidences control:

As for the Board's argument that the extensive regulation of taxi-drivers by municipal ordinance de facto gives the companies control over the driver's conduct on the job, the NLRB's position is not only inconsistent with precedent, but also evidences a misunderstanding of the effect of state regulation on the nature of the employer-employee relationship.

Government regulations constitute supervision not by the employer but by the state. Thus to the extent that the government regulation of a particular occupation is more extensive, the control by the putative employer becomes less extensive because the employer cannot evade the law either and in requiring compliance with the law he is not controlling the driver. Thus requiring drivers to obey the law is not more control by the lessor than would be a routine insistence upon the lawfulness of the conduct of those persons with whom one does business.

In the situation before us, whatever control is exercised is not the master's but that of the local government. That the state has chosen to so regulate cab drivers so that those who lease cabs can be reasonably confident of the conduct of the drivers while in their cabs does not mean that the lessors thereby "control" his conduct. That government regulation has made supervision or control by the lessor unnecessary is not the equivalent of the presence of actual supervision or control. [Emphasis added.]*

Thus, we urge that Congress clarify that where a third-party regulator imposes requirements on a worker and supervisory requirements on the business to make certain that the worker meets the regulatory agency's requirements and standards, any reasonable actions taken by the business to satisfy those supervisory requirements should be treated as neutral and not as evidence of either employee or independent contractor status.

C. Summary

Congress adopted the Exchange Act to assure securities consumers that the information they receive from registered representatives is informed and accurate. Compliance with Securities Exchange Commission and NASD regulations does not evidence broker/dealer control, but rather control exerted by the government in furtherance of its objective. Therefore, compliance with the requirements of the Exchange Act and the NASD, should not to be considered when assessing the "control" factor under the common law 20 factor test for worker classification.

Current law must be clarified to eliminate consideration of compliance with government regulations when determining worker classification. Such clarification could be accomplished either by eliminating the subjective 20 factor test in favor of objective standards, such as those contained in the legislative proposals pending in the House, or by clarifying legislatively the manner in which the common law control test should be administered by the IRS.

Thank you for your consideration of this issue of great importance to the securities industry.

² 603 F.2d 862 (D.C. Cir. 1978).

[§] Id. at 875-76.

LINDA SMITH, WASHINGTON CHARWOMAN MARTIN MEEHAN, MASSACHUSETTS

Congress of the United States

House of Representatives

101th Congress Committee on Small Business

Subcommittee on Taxation and Inance 18–363 Rayburn Rouse Office Building Washington, DE 20515

For Immediate Release: June 20, 1996 For information contact: Ligia McWilliams, 202-225-7673 or Kathryn Smith, 202-225-3536

Chair Smith Applauds Chair Johnson's Independent Contractor Hearings

Washington, D.C. - Rep. Linda Smith, Chair of the House Small Business Subcommittee on Taxation and Finance, today applauded Rep. Nancy Johnson, Chair of the House Ways & Means Subcommittee on Oversight, for holding hearings on the issue of worker classification.

"Chairwoman Johnson understands the need for new, clear criteria relating to worker classification, and her leadership is pivotal to a resolution," Smith said. "Because small business owners create the majority of jobs in America, they need clarity and consistency to continue to grow our economy," Smith added.

Chairwoman Smith held hearings on clarifying the status of independent contractors last year, after delegates from across the nation to the 1995 White House Conference on Small Business voted it their top legislative recommendation to President Clinton and to Congress. All witnesses who testified before Chairwoman Smith — including the IRS and the GAO — agreed the law must be clarified because it results in confusion and inconsistent tax treatment of workers. Yet, one year later, President Clinton's Administration has proposed no legislation to clarify the law.

"Congress must move forward now to protect our nation's small entrepreneurs from the large back taxes, penalties and interest they face when the IRS unfairly reclassifies independent contractors as employees," Smith urged. Chairman Johnson's first hearing last week revealed that far too many small businesses face this problem under today's law.

"H.R. 1972 is a strong bill in the right direction," Smith said about the key proposal before Congress which she co-sponsors. "In effect, slightly modified, it could provide a new, safe harbor for small businesses that hire legitimate independent contractors, so that all employers and workers can better rely on the law," Smith explained.

"But the IRS must change its focus under any new criteria Congress establishes," Smith reiterated, "or Congress' work will be in vain." While the IRS' has developed a new draft training manual which represents a good first step, it is based on today's criteria and continues to show a bias against independent contractors.

Software Industry Coalition

June 17, 1996

TO: Subcommittee on Oversight of the Committee on Ways and Means

RE: Classification of workers as employees or independent contractors for Federal tax purposes.

This testimony is submitted for consideration by the committee and for inclusion in the printed record of the June 4th hearing of the Oversight Subcommittee of the House Ways and Means Committee.

The Software Industry Coalition, based in California's Silicon Valley, consists of several of the software industry's leading edge companies. Collectively our members have over 126,000 employees and world-wide revenues of over \$36 billion.

The software industry is one of America's most rapidly changing industries. Software products typically experience a short life cycle, yet they require extensive development work to produce. In order for software companies to compete they must stay on the leading edge of the technology. This requires that they have access to technical expertise on a project by project as-needed basis, in a timely fashion. The best technical experts, being in high demand, frequently prefer to work within their own businesses as self-employed contractors rather than as employees.

High tech companies in California frequently rely these self-employed consultants to supply technical expertise for critical projects. A recent survey by the California Employment Development Department indicated that over 25% of software professionals in California are obtained through contracts with outside sources such as self-employed consultants. These working relationships are a major source of innovation in our high tech industries. The existence of this kind of industry support infrastructure plays a major part in the industry's global competitiveness.

Unfortunately, unclear rules for determining worker status can make these professional working arrangements extremely risky for the companies which need to obtain technical expertise from self-employed individuals. IRS "employment" audits can result in extreme penalties even in situations where all tax laws have been complied with. It is not unusual for IRS settlement agreements to call for the termination of worker contracts - with no input from the worker. For the high tech worker who is self-employed the audit of a client frequently results in the loss of work or forces the consultant into an undesired employment status which is detrimental to the small business person who has made significant investments in that business.

The problems with IRS employment classification audits have been plaguing U.S. companies and small businesses for years. Congress in 1978 enacted a safe harbor (Section 530) which was intended to provide temporary protection until such time as Congress could address the classification issue. Unfortunately Congress has been unable to agree on an appropriate definition of who is an employee and the Section 530 safe harbor has not proved to be a sufficient long term

solution. In addition, since 1986, high tech industries have been denied the protection of even that safe harbor

H.R. 1972 would resolve this problem by creating a safe harbor from employment classification for workers who are in business for themselves as indicated by specific conditions in the legislation. It would ensure that true small businesses are able to provide necessary services without threats of untimely contract termination due to IRS audits. H.R. 1972 would give our high tech companies the ability to rely on experts without fear of unjust penalties for doing so, provided that those experts were truly separate businesses as defined within the legislation.

The Software Industry Coalition has joined with the Joint Venture: Silicon Valley Tax Council in issuing a report entitled "Employment Classification Issues & Possible Solutions". H.R. 1972 implements the Coalition's recommendations. Furthermore, H.R. 1972 is strongly supported by both self-employed consultants and by the companies who need their services.

The Software Industry Coalition believes that H.R. 1972 will bring much needed relief to businesses in our industry. However, there is one technical correction should be made in H.R. 1972: the act should apply to the entire title rather than to the subtitle.

The Software Industry Coalition believes that H.R. 1972, by providing a clearly defined set of circumstances under which a service provider and service recipient can do business without fear of IRS interference, will by those provisions alone increase 1099 filing. That result would be due to the removal of the current existing disincentive to filing: the fear of an unreasonable employment classification audit. The additional requirement that 1099's be filed in order to fall under the "safe harbor" definitions of H.R. 1972 will even further increase 1099 filing. Whether any additional benefit would be provided by increasing penalties for non-filing is therefore difficult to determine. On the other hand, we believe that any increase in penalties MUST be accompanied by a safe harbor definition of who is not an employee, if we are to avoid doing additional damage to America's small businesses.

We would like to point out that it is also necessary to retarget penalties which currently exist for errors made in reporting taxpayer ID or SS #'s on 1099 forms. Currently it is the service recipient who is penalized if the worker provides an incorrect ID #. This is not appropriate, especially when the service recipient has no way to validate the correctness of that number. It is the service provider, whose ID # it is, who should be penalized for providing an incorrect ID #.

While the IRS has developed a new classification settlement program, we note that it requires that workers be reclassified as employees in order to qualify. Unfortunately the worker's preferences are not considered in this decision. The client can agree to reclassify the worker and then can discontinue the employment relationship. Furthermore, many consultants do not work as employees and the "settlement" program merely ensures that they lose a client. While we agree that the IRS is making some improvements in this area there is no obligation on the part of the IRS to maintain those improvements once the threat of legislation is removed. That is exactly why passage of H.R. 1972 is so necessary. U.S. businesses should be able to rely on the law - not on the whims of the IRS - to protect their business relationships.

This legislation is important to our country's competitiveness in software and other high tech industries. It is time, indeed it is past time, for Congress to act on this issue. We strongly recommend that Congress move forward, amend HR 1972 to be effective for the entire title, and enact this important legislation.

Please contact Kaye Caldwell, the Coalition's Policy Project Director at 408-479-8743 if we can be of further assistance on this issue.

STATEMENT

Ωn

WORKER CLASSIFICATION for submission to the

SUBCOMMITTEE ON OVERSIGHT

of the

HOUSE COMMITTEE ON WAYS AND MEANS

for the

U.S. Chamber of Commerce

by

William T. Sinclaire

Senior Tax Counsel and Director of Tax Policy
June 4, 1996

The U.S. Chamber of Commerce — the world's largest business federation, representing 215,000 business members, 3,000 state and local chambers of commerce, 1,200 trade and professional associations and 76 American Chambers of Commerce abroad — appreciates this opportunity to express its views on the classification of workers as employees or independent contractors for federal tax purposes.

The proper classification of workers is a problem plaguing the small business community and was considered the most important small business issue by the delegates attending the 1995 White House Conference on Small Business. More than 96 percent of the Chamber's members are small businesses with fewer than 100 employees, 71 percent of which have fewer than 10 employees. It is vital to the growth and strength of our nation's small businesses that the current worker classification rules be clarified and simplified.

It is crucial that a business properly classify its workers since such classification establishes who is responsible for paying, collecting and/or remitting various payroll taxes, such as income, Social Security and unemployment taxes, to the Internal Revenue Service (IRS). A business that hires employees to perform services is responsible for withholding payroll taxes from the employees' wages and is subject to certain payroll taxes itself. In contrast, a business that hires independent contractors to perform services is not required to withhold payroll taxes from payments made to such workers and is not subject to any payroll taxes itself.

However, properly classifying workers can be arduous and risky for many businesses, given the complexity, ambiguity and subjectivity that exist in current law (the 20-factor common-law test and the Section 530 safe-harbor rules). The unintentional misclassification of workers can lead to costly and time-consuming audits and the assessment of significant back taxes, penalties and interest by the IRS. To satisfy these levies, businesses sometimes lay off workers, sell productive assets or — in worst case scenarios — file for bankruptcy protection.

CURRENT LAW

20-Factor Test

A worker is considered to be an employee if the business is able to "control" the way in which the worker's services are performed. If the business does not have such control over the service-provider, he or she is considered to be an independent contractor.

In order to determine whether a business has the requisite control over a worker's services, a 20-factor test is applied. Some of these factors include:

- Does the business dictate how, when and where the work is to be performed?
- What is the profit-making ability of the worker?
- Does the worker provide services to others?
- Does the worker use company-provided tools and/or materials?
- What is the compensation arrangement between the business and the worker?

Determining whether "control" exists from these factors can be very subjective since they involve varying "facts and circumstances". The 20-factor test, therefore, often leads to disputes between businesses and the IRS.

Section 530 Safe-Harbor Rules

If, under the 20-factor test, a service-provider is determined to be an employee, he or she may still be treated as an independent contractor if certain "safe-harbor rules" are met. To qualify for independent-contractor status under these rules, the service-recipient must have a "reasonable basis" for treating the worker as an independent contractor, treat all workers in similar positions the same way, and file all required forms with the IRS. To have a reasonable basis for purposes of satisfying the first condition, the business must rely on the results of a prior audit, judicial precedent, industry practice, or another acceptable basis.

Statutory Employees / Statutory Nonemployees

Certain types of workers are considered "statutory employees" and "statutory nonemployees" and, therefore, are not subject to the 20-factor test or the safe-harbor rules. For example, certain types of drivers, domestic workers and traveling salespeople are statutorily treated as employees, while real estate agents and direct sellers are treated as nonemployees, i.e., independent contractors.

LEGISLATIVE PROPOSALS

Several legislative proposals have been introduced in the 104th Congress which would establish clearer and more objective criteria for determining worker-classification status.

The Independent Contractor Tax Simplification Act of 1995 (H.R. 1972)

Introduced by Representative Jon Christensen (R-NE), this bill would allow a worker to be treated as an independent contractor if the following three tests are met:

- (1) The worker either:
 - (a) makes significant investments in assets and/or training,
 - (b) incurs significant unreimbursed expenses,
 - (c) agrees to perform the service for a particular amount of time to achieve a designated result and accepts liability for damages for noncompliance without cause.
 - (d) is paid primarily on a commission basis, or
 - (e) purchases products for resale.
- (2) The worker either:
 - (a) has a principal place of business other than at the firm, or
 - (b) intends to offers services to other recipients.

(3) A written contract exists stating that the services are being provided and that the person providing the services will not be treated as an employee.

In order to qualify under the above tests, a service-recipient would have to comply with all income-reporting requirements.

The Independent Contractor Tax Simplification Act of 1996 (S. 1610)

Introduced by Senators Christopher S. Bond (R-MO) and Don Nickles (R-OK), this bill is almost identical to H.R. 1972.

The Independent Contractor Tax Fairness Act of 1995 (H.R. 582)

Introduced by Representative Jay Kim (R-CA), this bill would accomplish four objectives. First, it would allow a worker to be treated as an independent contractor if the services are performed pursuant to a written contract, and one of the following criteria is met:

- (1) The worker can make a profit or suffer a loss;
- (2) The worker maintains a separate principal place of business other than at the firm and has a significant investment in facilities or tools:
- (3) The worker makes his/her services available to the public on a consistent basis and has provided such services as an independent contractor to at least one other service-recipient during the current or previous year; or
- (4) The worker is paid exclusively on a commission basis, and either:
 - (a) has a principal place of business other than at the firm, or
 - (b) pays fair-market value for rent at the firm.

Second, it would require the Secretary of the Treasury to propose legislation that would provide objectively measurable standards for classifying workers who do not meet one of the foregoing criteria. Third, it would repeal the safe-harbor rules and codify them with modifications. Finally, it would shift the IRS' focus from reclassifying workers to enforcing tax compliance among independent contractors by (a) increasing the penalties levied against service-recipients for failing to issue information returns (Form 1099) to service-providers and (b) requiring independent contractors to list their business income separately on their income tax returns.

IRS' REVISION OF TRAINING MATERIALS

The IRS recently released a draft of revised training materials on the current worker-classification rules. The revised training materials, however, are limited in what they can accomplish. They cannot, and do not, change existing law. Their primary purpose is to train IRS examiners on worker classification issues. The present maze of rules needs to be simplified and made more objective. These goals cannot be met by issuing revised training materials; they can only be achieved through legislation because the IRS is statutorily precluded by Section 530(b) of the Revenue Act of 1978 from issuing public guidance — such as regulations and revenue rulings — on the topic.

CONCLUSION

The Chamber believes strongly that simplification and clarification of the current worker classification rules is long overdue, and that the foregoing legislative proposals would help alleviate many of the problems associated with such rules. In addition to providing business owners with clearer and more objective criteria on which to make classification determinations, these proposals recognize the importance of independent

contractors in today's work environment.

While the Chamber supports the foregoing legislation, there are several concerns. H.R. 1972, H.R. 582 and S. 1610, according to their sponsors, would maintain the 20-factor test and safe-harbor rules, and a literal reading of these bills supports such assertions. However, if any of these proposals, in their present or some modified form, is enacted into law, the proposal would be subject to interpretation by the IRS — a process involving the examination of the bill's legislative history and intent. Accordingly, the IRS could, depending on such bill's legislative history and intent, interpret the bill as repealing the 20-factor test and/or safe-harbor rules. This could be detrimental to businesses that currently rely on existing law to classify workers as independent contractors, but would be unable to do so under new legislation. Therefore, it should be made absolutely clear in the bills' legislative language and/or history that neither the 20-factor test nor the Section 530 safe-harbor rules would be repealed or otherwise nullified.

Furthermore, since H.R. 582 would repeal the Section 530 safe-harbor rules and codify them in a modified form, particular attention should be given to protecting those businesses that have relied on the existing safe-harbor rules from any adverse consequences resulting from the rule's demise and codification.

We appreciate this opportunity to address this very important issue.

C



IMPACT OF TAX LAW ON LAND USE

HEARING

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT

OF THE

COMMITTEE ON WAYS AND MEANS HOUSE OF REPRESENTATIVES

ONE HUNDRED FOURTH CONGRESS

SECOND SESSION

JULY 16, 1996

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IMPACT OF TAX LAW ON LAND USE

TUESDAY, JULY 16, 1996

House of Representatives, Committee on Ways and Means, Subcommittee on Oversight, Washington, DC.

The Subcommittee met, pursuant to call, at 11:10 a.m., in room 1100, Longworth House Office Building, Hon. Nancy L. Johnson (Chairman of the Subcommittee) presiding.
[The advisories announcing the hearing follow:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

SUBCOMMITTEE ON OVERSIGHT

FOR IMMEDIATE RELEASE June 21, 1996 No. OV-15 CONTACT: (202) 225-1721

Johnson Announces Hearing on the Impact of Tax Law on Land Use

Congresswoman Nancy L. Johnson (R-CT), Chairman of the Subcommittee on Oversight of the Committee on Ways and Means, today announced that the Subcommittee will hold a hearing on the impact of Federal tax law on land use. The hearing will take place on Thursday, July 11, 1996, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 10:00 a.m.

BACKGROUND:

The Internal Revenue Code includes a number of provisions that have an impact on land use. Among them are the tax credit for rehabilitation expenditures; incentives for locating businesses in empowerment zones (an employment and training credit, an additional \$20,000 per year in section 179 expensing, and a new category of tax-exempt private activity bonds); the tax treatment of environmental remediation costs; preservation easements to minimize Federal estate taxes; an income tax deduction for donating an easement to a qualified organization for conservation purposes; and an estate tax preference for farms and small businesses.

In announcing the hearing, Chairman Johnson stated: "A number of provisions of current tax law have both intended and unintended consequences for land use. For instance, owners of historic property can establish preservation easements before they die to minimize Federal estate taxes and to protect the property in perpetuity. They can also take a deduction for contributing the easement to a qualified organization. The public policy objective is clear.

On the other hand, some have argued that current cost recovery provisions discourage businesses from investing in urban areas. A plant or equipment can be depreciated, but the land on which a factory is built cannot. That often means that a greater portion of an investment in non-urban areas can be depreciated. We need to look at whether this discourages businesses from investing in cities."

FOCUS OF THE HEARING:

A number of these provisions were enacted piecemeal over the years. The hearing will examine the net effect, if any, of the various provisions on land use decisions.

DETAILS FOR SUBMISSIONS OF REQUESTS TO BE HEARD:

Requests to be heard at the hearing must be made by telephone to Traci Altman or Bradley Schreiber at (202) 225-1721 no later than the close of business, Monday, July 1, 1996. The telephone request should be followed by a formal written request to Phillip D. Moseley, Chief of Staff, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. The staff of the Subcommittee on Oversight will notify by telephone those scheduled to appear as soon as possible after the filing deadline. Any questions concerning a scheduled appearance should be directed to the Subcommittee staff at (202) 225-7601.

(MORE)

In view of the limited time available to hear witnesses, the Subcommittee may not be able to accommodate all requests to be heard. Those persons and organizations not scheduled for an oral appearance are encouraged to submit written statements for the record of the hearing. All persons requesting to be heard, whether they are scheduled for oral testimony or not, will be notified as soon as possible after the filing deadline.

Witnesses scheduled to present oral testimony are required to summarize briefly their written statements in no more than five minutes. THE FIVE-MINUTE RULE WILL BE STRICTLY ENFORCED. The full written statement of each witness will be included in the printed record.

In order to assure the most productive use of the limited amount of time available to question witnesses, all witnesses scheduled to appear before the Subcommittee are required to submit 200 copies of their prepared statements for review by Members prior to the hearing. Testimony should arrive at the Subcommittee on Oversight office, room 1136 Longworth House Office Building, no later than 10:00 a.m. on Tuesday, July 9, 1996. Failure to do so may result in the witness being denied the opportunity to testify in person.

WRITTEN STATEMENTS IN LIEU OF PERSONAL APPEARANCE:

Any person or organization wishing to submit a written statement for the printed record of the hearing should submit at least six (6) copies of their statement, with their address and date of hearing noted, by the close of business, Thursday, July 25, 1996, to Phillip D. Moseley, Chief of Staff, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements wish to have their statements distributed to the press and interested public at the hearing, they may deliver 200 additional copies for this purpose to the Subcommittee on Oversight office, room 1136 Longworth House Office Building, at least one hour before the hearing begins.

FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines inted below. Any statement or stabilit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

- All statements and any accompanying exhibits for printing must be typed in single space on legal-time paper and may not exceed a total of 10 pages including attachments.
- Copies of whole documents submitted as exhibit material will not be accepted for printing, instead, exhibit material sheaded be referred and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee Elies for review and use by the Committee.
- A witness appearing at a public hearing, or submitting a statement for the record of a public hearing, or submitting written comments in response to a published request for comments by the Committee, must include on his statement or submission a list of all clients, persons, or organizations on whose behalf the victores appeared.
- 4. A supplemental sheet must accompany each statement listing the name, full address, a telephone number where the witness or the designated representative may be reacted and a topical outline or nummary of the comments and recommendations in the full extensent. This supplemental below will not be included in the partial record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or experimentary material submitted solely for distribution to the Members, the press and the public during the course of a public hearing may be submitted in other forms.

Note: All Committee advisories and news releases are now available on the World Wide Web at 'HTTP://WWW.HOUSE.GOV/WAYS_MEANS/' or over the Internet at 'GOPHER.HOUSE.GOV' under 'HOUSE COMMITTEE INFORMATION'.

NOTICE -- CHANGE IN DATE/TIME/LOCATION

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

SUBCOMMITTEE ON OVERSIGHT

FOR IMMEDIATE RELEASE

July 2, 1996 No. OV-15-Revised CONTACT: (202) 225-7601

Change in Date/Time/Location for Subcommittee Hearing on the Impact of Tax Law on Land Use

Congresswoman Nancy L. Johnson (R-CT), Chairman of the Subcommittee on Oversight of the Committee on Ways and Means, today announced that the Subcommittee hearing on the Impact of Tax Law on Land Use previously scheduled for Thursday, July 11, 1996, at 10:00 a.m., in 1100 Longworth House Office Building, will be held instead on Tuesday, July 16, 1996 at 11:00 a.m., in room B-318 Rayburn House Office Building.

All other details for the hearing remain the same. (See Subcommittee press release No. OV-15, dated June 21, 1996.)

***NOTICE -- CHANGE IN LOCATION**

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

SUBCOMMITTEE ON OVERSIGHT

FOR IMMEDIATE RELEASE July 15, 1996 No. OV-15-Revised CONTACT: (202) 225-7601

Room Change for Subcommittee Hearing on Tuesday, July 16, 1996, on the Impact of Tax Law on Land Use

Congresswoman Nancy Johnson, (R-CT), Chairman of the Subcommittee on Oversight of the Committee on Ways and Means, today announced that the Subcommittee hearing on the Impact of Tax Law on Land Use previously scheduled for Tuesday, July 16, 1996, at 11:00 a.m., in B-318 Rayburn House Office Building, will be held instead in room 1100 Longworth House Office Building.

All other details for the hearing remain the same. (See Subcommittee press release No. OV-15, dated June 21, 1996, and No. OV-15-Revised, dated July 2, 1996.)

Note: All Committee advisories and news releases are now available on the World Wide Web at 'HTTP://WWW.HOUSE.GOV/WAYS_MEANS/' or over the Internet at 'GOPHER.HOUSE.GOV' under 'HOUSE COMMITTEE INFORMATION'.

Chairman JOHNSON. The hearing will come to order. Good morning. It is a pleasure to have so many of my colleagues with us.

It is no secret that some of our Nation's most scenic open spaces are disappearing at a time when many cities; large and small, are decaying. There are many reasons for this, the development of the interstate highway system, relatively inexpensive commuting costs and tax incentives for home ownership, to name but a few.

Obviously, public safety, the quality of schools, the financial health of the Nation's cities figure prominently in decisions to move businesses and family to the suburbs. But a wide array of tax features have an impact as well, and as Congress considers a major overhaul of Federal tax laws, it is essential that we have a better

understanding of the cumulative effect of these provisions.

For instance, it is difficult to recover many of the costs of development in urban areas. Many of the costs have to be capitalized into the basis of the land rather than into the depreciable basis of the building. On the other hand, the rehabilitation tax credit leveraged \$483 million in private development activity in 1994 at a cost to the Treasury of \$97 million. Saving historic buildings has helped revitalize a number of urban neighborhoods throughout the country. The rules surrounding the tax treatment of environmental remediation expenses are so convoluted and so confusing, it is no wonder that a number of businesses decide to sidestep them altogether and invest in newer buildings outside the environmentally distressed areas.

In rural areas, estate taxes can have a tremendous impact on land use decisions. According to one of our witnesses, the Piedmont Environmental Council, farmland that sold for \$500 an acre in the sixties is selling for \$10,000 and \$15,000 an acre today. The tax cost of passing along such expensive acreage to the next generation, coupled with the pressure for development in many areas, is a major reason for the disappearance of open spaces.

There are features in current law to try to offset this. Family farms and businesses can be taxed on their current use value rather than full market value. Taxpayers can take a deduction for establishing conservation easements. Some have suggested that these provisions are inadequate. We will be hearing from several of our

colleagues and other witnesses about alternatives.

Other provisions of the tax law that come into play include the deductibility of mortgage interest, an array of private activity taxexempt bonds, and the treatment of investments and empowerment

and enterprise zones.

Our colleagues, Charlie Rangel and Jim Talent and J.C. Watts have introduced enterprise zone legislation to build on and expand current empowerment zones in enterprise communities. Saving our cities and preserving our countryside, two of our Nation's most precious resources, are different sides of the same coin. We cannot accomplish one without the other.

Are all the answers to be found in the Tax Code? Of course not. But at the moment we may not even understand how many of the

problems are exacerbated by the Tax Code.

There is an old parable about a flea riding on an elephant's back. They came to a stream and were crossing over on a bridge. When they finished crossing, the flea said to the elephant, "Boy, we sure

shook that bridge, didn't we?"

Clearly, there are limits to what we can accomplish with the tax law, but we surely owe it to ourselves to make sure that we understand current law to satisfy ourselves that current law is not making matters worse, take corrective action if it is needed, and perhaps to find better ways to use tax law to both save our cities and open spaces.

Let me recognize my colleague, Mr. Matsui.

Mr. MATSUI. Well, I would just like to commend the Chair for holding these hearings.

I have a statement, and I will submit it for the record, but I do

want to commend you and thank you for these hearings.

[The prepared statement follows:]

OPENING STATEMENT OF CONGRESSMAN MATSUI

HEARING ON THE IMPACT OF FEDERAL TAX LAWS ON LAND USE

SUBCOMMITTEE ON OVERSIGHT

JULY 16, 1996

At today's hearing, the Oversight Subcommittee will receive testimony from Members of Congress and the public about the impact of the Federal tax laws on land use.

I commend Chairwoman Johnson for scheduling this hearing, and look forward to hearing the witnesses' suggestions about proposals the Congress should consider to preserve this Nation's environment, to enhance our preservation of open space, and to revitalize our distressed communities.

The Subcommittee will receive testimony about: the tax credit for rehabilitation expenditures; incentives for locating businesses in empowerment zones and enterprise communities; initiatives for "brownfield" redevelopment and the tax treatment of environmental remediation costs; preservation easements to minimize estate taxes; and, estate tax preferences for farms and small businesses.

I should note that officials from the Department of the Treasury were unable to appear at today's hearing, due to the disruption resulting from the recent fire at main Treasury. However, the Administration has provided the Subcommittee with extensive information about their fiscal year 1997 budget proposals and will submit a written statement for the Subcommittee's hearing record.

In summary, the Administration proposes (as contained in H.R. 3747, introduced by Congressman Rangel) tax incentives for the clean-up of environmentally-contaminated urban and rural areas (known as "brownfields"), the designation of two additional urban empowerment zones within 180 days of enactment, authorization of 40 additional empowerment zones and 65 additional enterprise communities, and various enhanced tax benefits (including the availability of tax-exempt bond financing).

In a time of decreased Federal resources, we all must find new ways to address these important issues, and to revitalize our rural and urban areas in the process of decay.

I welcome the insight of the witnesses testifying before us today, and look forward to our discussion of the impact the Federal tax laws have on land use decisions.

Chairman JOHNSON. Thank you.

I am pleased to have with us so many of our colleagues who have given this issue a lot of thought, and thereafter a number of national organizations as well as local groups who are working hard and are very conscious of both the advantages and disadvantages of the current structure of our tax laws.

I am pleased also to have so many Members of the Ways and Means Committee.

Let me start with Hon. Clay Shaw.

STATEMENT OF HON. E. CLAY SHAW, JR., A REPRESENTATIVE IN CONGRESS FROM THE STATE OF FLORIDA

Mr. SHAW. Thank you, Madam Chairman.

As long as I have been on this Committee, it is the first time I have been at this table. You all are sitting a lot higher than I thought you were.

I would like to take this time this morning to briefly discuss a bill which I feel is very important to the purpose of this hearing.

I introduced H.R. 1662, the Historic Homeownership Assistance Act, along with our colleague, Barbara Kennelly, to provide prospective homeowners with a powerful incentive to help preserve and protect our Nation's historic homes and communities. It currently has 75 cosponsors. The bill, as others at this hearing will state, will accomplish several important goals in a cost-effective manner.

The first is enhanced home ownership. The credit would be available for those who purchase and renovate historic homes as their principal residences. Both single and multifamily homes may be rehabilitated. Twenty percent of the cost of the work could then be credited against the homeowner's Federal income tax liability, and that would have a cap of \$50,000 per homeowner. If a developer repairs the home, the credit can pass through to the person who purchases the home from the developer. All of these provisions will make acquiring a qualified property much more attractive to the home buyers.

Second, I believe that this bill will be of great use to the communities which are struggling to restore their vitality. Over the past several decades, our cities have seen a virtual abandonment of large amounts of housing units. In order to bring people and businesses back into the city, we have to make housing a more attractive investment.

This Nation possesses massive urban infrastructure which is grossly underutilized. Instead of further extending suburban sprawl, we need to concentrate on restoring existing areas. While no panacea, H.R. 1662 would certainly be a step in the right direction.

Third, H.R. 1662 will help to achieve large-scale preservation of historic homes all over this country. I cannot emphasize enough how important it is to protect this vital American resource. Older homes are reminders of, and connections to, our Nation's history and our past. For all of the reasons I have spoken of, Madam Chairman, I believe that H.R. 1662 should be enacted.

Finally, as we have discovered over the past several decades, it is difficult to preserve not only historic homes and neighborhoods

but also open lands and family farms. One of the main causes of the phenomenon of sprawl is the Tax Code, which often provides a disincentive to invest in existing infrastructure. In order to achieve our common goals of heritage and preservation, we must provide our homeowners, farmers, and families with a Tax Code that respects and fosters both our past and our future.

Having restored one of these old homes, I believe—I know, Madam Chairman, you have been in that home, and you live in one of the older homes here in the District—it is very expensive. These old homes are very temperamental, but I think it is very important that they be preserved instead of bulldozed, and I can tell you also, as a former mayor, that this would be tremendously important to the inner cities particularly and could help us out tremendously in the revitalization of our great cities.

Thank you.

Chairman JOHNSON. Thank you.

Mr. Houghton.

STATEMENT OF HON. AMO HOUGHTON, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW YORK

Mr. HOUGHTON. Thank you, Madam Chairman, for the opportunity to testify.

I ask that my written statement be included in the record.

I am here with my friend and colleague, L.F. Payne, to briefly discuss our bill, H.R. 864, which is the American Farm Protection Act. I might say that in addition to Mr. Payne, myself, and yourself, there are 11 other Members of the Ways and Means Committee who are cosponsors of this bill.

Now let me make four points very briefly.

First, why do we need such a bill? Because the family farms and ranchland around the urban areas and in our national parks is being developed at a very rapid rate. The development value of such property may greatly exceed the farming value of such property, forcing the sale on the death of the owner to pay estate taxes.

Second, how does the bill solve the problem? What it does is provide an exclusion from estate and gift taxes for the value of farmor ranchlands subject to a qualified land conservation easement, and that is within 50 miles of a metropolitan statistical area or national park. That is pretty straightforward.

Third, does the Code already provide relief? Even though there are presently a number of measures in the Internal Revenue Code to provide some relief, they frankly are not effective. They just don't work.

Fourth, our bill provides for the conservation of America's important farm- and ranchland really through voluntary action without regulation, without cost of public acquisition and maintenance, and without taking land off the local tax roles.

Thank you, Madam Chairman. That is my statement.

[The prepared statement follows:]

STATEMENT OF THE HONORABLE AMO HOUGHTON (R., NY) MEMBER, COMMITTEE ON WAYS AND MEANS BEFORE THE SUBCOMMITTEE ON OVERSIGHT ON THE IMPACT OF TAX LAW ON LAND USE JULY 16. 1996

Thank you, Madam Chairman, for the opportunity to testify before your subcommittee.

This is an issue of importance, and one in which I have been involved during this Congress. I am delighted to join my colleague, L.F. Payne, who also has been deeply involved for many years.

As you and I and anyone living in rural and suburban areas of this country know, much of America's (historically and environmentally significant) land is under development pressure. This is often out of proportion to the expected demands of population growth, as sprawl leapfrogs development far beyond metro centers. Furthermore, this pressure is intensified by Federal tax laws. in particular estate tax law.

Specifically, the value of land in those parts of the country where ranches, farms and forests traditionally have flourished has skyrocketed — this to the point where landowners' children can no longer afford the estate tax bill after their parents die. The result is predictable — landholdings are split up and sold. The problem of course is that their land is often some of the best and most productive agricultural land in the nation. Today provisions in the law provide little or no relief from this burden, nor are current incentives in the law to preserve this land in its current, or a less developed state sufficiently attractive or workable to have much success.

That is why Mr. Payne and I, along with you, Madam Chairman, and 3 other members of your subcommittee, as well as 8 of our colleagues on the full Committee in a bipartisan effort have introduced H. R. 864, the American Farm Protection Act.

The American Farm Protection Act addresses the problem faced by the current generation of farm and ranch owners. It also provides an incentive to conserve valuable farm and ranchland in this country. The legislation does this by providing an exclusion from the estate and gift tax for the value of the portion of the decedent's estate that consists of land subject to a qualified conservation easement.

The American Farm Protection Act would enable America's farm and ranch families to continue to do what they do best: take care of America's rural lands. It would eliminate the Federal Government from a family's decision whether to maintain the farm, ranch, or forest. In other words, the American Farm Protection Act protects farm, ranch and forest land and the families who own it. It does so without regulation, without taking the land off the local

and state tax rolls, and without imposing on the American taxpayer the costs of acquisition, administration, or maintenance of the land. The legislation provides an entirely <u>voluntary</u> <u>approach</u> for a rural landowner to use to preserve the land for rural purposes.

I believe our bill can be an important tool for America's farm and ranch families. It will permit them to preserve their homesteads, and at the same time make a significant contribution to the larger public good of conserving America's increasingly threatened rural lands.

As you know, Madam Chairman, a more limited version of our legislation was included in the vetoed Balanced Budget Act of 1995. We look forward to seeing our original bill included in the next viable tax vehicle that comes through this Committee.

Thank you for the opportunity to testify. I now defer to my colleague and an original sponsor of this important legislation, Congressman Payne.

Mr. HOUGHTON. I would like now to defer to my colleague, Congressman Payne.

Chairman JOHNSON. Yes. Mr. Payne.

STATEMENT OF HON. L.F. PAYNE, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF VIRGINIA

Mr. PAYNE. Thank you very much, Madam Chairman, Mr. Matsui, members of the panel. And thank you, Amo, for all the work that you have done on this legislation, the American Farm Protection Act, H.R. 864.

As it relates to the future, as it relates to future generations, I truly believe that this is perhaps one of the most important pieces of tax legislation that we can enact in this Congress. I want to thank all of my colleagues who are here and have cosponsored this bill, and I would urge others to join us in this effort.

Every day our country loses over 4 square miles of farmland to development. One of the criticisms that we hear of a bill such as this is that what we are doing is looking at ways that will add loopholes for wealthy people. In that regard let me take my few minutes, if I might, to tell you about one such person who would be affected by this—one such family that would be affected by this legislation.

Bob Lange is a full-time farmer in Malvern, which is a small town 24 miles west of Philadelphia in Chester County, Pennsylvania. Bob was here before us, the Ways and Means Committee, on this very issue and testified in the last Congress. He operates a family farm which is currently owned by his 93-year-old grandmother and has been in his family since 1896. His farm is 226 acres. It is an active farm, everything from corn to strawberries to pumpkins, but because of its proximity to Philadelphia, the fair market value of his farmland is 10 to 15 times higher than typical farmland in Pennsylvania. This is because the fair market value is determined by looking at what that land would be worth if it was developed for residential or commercial purposes and not for its current farm use.

This is a crucial point, because when the owner of this farm dies, the Federal estate tax law requires the fair market value of the farm as developed land be included in the decedent's estate. Most heirs like Bob cannot afford the estate tax bill when the farm is valued in this manner. Even when you take advantage of the limited provisions in the existing tax law, including the unified credit deduction for the donation of qualified conservation easements, farm families typically don't have enough liquid assets to pay an estate tax of as much as 55 percent of the estate's value.

So this is not a bill that is designed to provide some tax relief for the rich; this is for farm families across this country to ensure that they would be able to maintain their farms and be able to continue to use those as they have in the past and not be forced to sell off parts of these or split these up.

This is also, as Amo has already pointed out, the very best way that we could act to ensure that we maintain good, open spaces in and around our national parks and in and around our metropolitan

areas.

We think this is good legislation. It is supported by not only a lot of Members on this Committee and in Congress, both Democrats and Republicans, but groups such as the American Farm Bureau, the National Farmers Union, the American Farm Land Trust, the Land Trust Alliance, the National Trust for Historic Preservation, the National Audubon Society, the National Forest Council, and many others. We would hope that in the remaining time that we have in this Congress that this legislation could be moved forward and could become law.

Thank you very much. I would like to put my statement into the record.

Chairman JOHNSON. So ordered. [The prepared statement follows:]

Statement of Rep. L.F. Payne Subcommittee On Oversight Committee on Ways and Means July 16, 1996

Thank you, Amo, for your remarks, and thank you, Madam Chairman, for this opportunity to testify before the Subcommittee on oversight on these important land issues. I have had the privilege of working with Amo this Congress on the American Farm Protection Act, which I had introduced last Congress as the Open Spaces Preservation Act. I truly believe this is one of the most important pieces of tax legislation that we could enact this year. I also want to thank all of my colleagues who have cosponsored this bill, and I would urge others to join us in this effort.

Every day this country loses over 4 square miles of farmland to development. The reasons are multiple, but the Federal estate tax plays a significant role in this phenomenon. To understand why, take the case of Bob Lange, a full-time farmer in Malvern, a small town 24 miles west of Philadelphia in Chester Country, Pennsylvania.

Bob testified before the Ways and Means Committee on this issue during the last Congress. He operates his family's farm, which is currently owned by his 93-year-old grandmother, and has been in the family since 1896. The farm is 226 acres. It is an active working farm. Bob grows everything from corn to strawberries and pumpkins. Because of its proximity to Philadelphia, however, the fair market value of his farmland is 10 to 20 times higher than typical farmland in Pennsylvania. This is because fair market value means the value of the land when developed for residential or commercial purposes, not the value at its current farm use. This is a crucial point, because when the owner of the farm dies, the federal estate tax law requires that the fair market value of the farm as developed land be included in the decedent's estate.

Most heirs cannot afford the estate tax bill when the farm is valued in this manner. Even taking full advantage of the limited relief provisions in the tax law, including the unified credit and the deduction for the donation of qualified conservation easements, farm families typically do not have the liquid assets to pay an estate tax of a much as 55% of the estate's value.

The tax law's special valuation rules for farmland appear intended to reduce this burden. However, the complexity of the section makes it very difficult for most farm families to understand or use. Also, there is a cap on the amount by which the value of the estate can be reduced. Moreover, the fact that a Federal tax lien remains on the property during the recapture period makes this relief unworkable for farm families, whose need for operating loans to farm continues. Thus, the heirs are forced to sell some or large portions of the farm to meet their tax obligations. Sale of even a portion of the farm may make the remainder uneconomical as a farming unit.

That is why Amo and I, along with you, Madam Chairman, and, as Amo noted, 3 other members of this Subcommittee, as well as 8 of our colleagues on the full Committee, in a bipartisan effort, have introduced H.R. 864, the American Farm Protection Act.

There are some who persist in criticizing any kind of meaningful estate tax relief as a special interest provision for the wealthy. Bob Lange is not a wealthy man. He holds an asset that is valuable only if it is put to a use other than the one it is currently serving -- a use, moreover, that would destroy everything Bob and his family have labored for three generations to preserve. I do not believe that Congress could have intended the estate tax laws to force the break-up and sale of this country's family farms, ranches, and environmentally significant forests and wetlands because there is a hypothetical chance that these landowners could be wealthy.

I believe we will have missed a priceless opportunity to leave something other than a huge federal debt to our children and grandchildren if we fail to get this bill enacted. By offering people an incentive to conserve America's increasingly threatened rural lands, while at the same time enabling them to keep their family homesteads intact, we will have given our children and grandchildren a better chance of enjoying a healthy environment and a comparable standard of living.

As you know, Madam Chairman, a more limited version of our legislation was included in the vetoed Balanced Budget Act of 1995. I urge my colleagues to support our efforts to include our original bill in the next viable tax vehicle that comes through this Committee.

Later today, you will hear from one of my constituents, the Piedmont Environmental Council, who will give you a more detailed and technical explanation of the effects of present law on family farms, ranches, forests and other rural and environmentally sensitive land. I appreciate the opportunity to testify with my good friend Amo Houghton today.

Chairman JOHNSON. Mr. English.

STATEMENT OF HON. PHILIP S. ENGLISH, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF PENNSYLVANIA

Mr. ENGLISH. Thank you, Madam Chair, Members of the Sub-committee. I want to thank you for the opportunity to testify here today at this hearing and to speak to the provisions of the American Community Renewal Act of 1996, H.R. 3467. By your leave, I would like to submit my testimony for the record and make some general comments.

This legislation, which was introduced by Representatives J.C. Watts, Jim Talent, and 46 others, including myself, will be examined much more closely and by a number of other Committees because it is broad-ranging legislation. However, today I specifically want to focus on a number of tax provisions in the bill and how the implementation of these provisions relates to current law and disincentives for businesses to invest in depressed communities.

The Community Renewal Act is designed to revitalize families, neighborhoods, and local business areas in America's impoverished communities. H.R. 3467 will provide greater economic opportunities and new hope for millions of disenfranchised Americans trapped in poverty. It will do so by encouraging private sector job creation in the community, providing opportunities for home ownership, and bolstering private charitable activity, along with a number of other incentives.

Title I of the legislation builds on the enterprise zone legislation concept that has been before Congress in the past. It includes the tax incentives in the Abraham-Lieberman bill currently in the Senate which contains legislation I introduced in the House, the Commercial Revitalization Tax Act, H.R. 2138, and the Riggs, English, and Weldon bills in the House on enterprise zones.

The purpose of title I is to liberate the economic forces within disadvantaged communities through the Tax Code by fostering an atmosphere where real private sector businesses and jobs are created and recognizes that new and expanding small businesses are best suited to provide jobs, particularly in urban neighborhoods. It comes invested with specific ideas that urban entrepreneurs believe are necessary to restore the economy in depressed communities.

Specifically, title I would create 100 renewal communities. To qualify, a community would have to have a poverty rate of 20 percent or more, an unemployment rate of at least 1.5 times the national rate, and at least 70 percent of the households having incomes below 80 percent of the median level of households, and have a population decline of 20 percent or more between 1980 and 1990.

Second, it would require that local communities reduce tax rates and fees within zones and eliminate State and local taxes to be eligible for community designation.

Third, it would create substantial Federal tax incentives for renewal communities, including an elimination of the capital gains tax on investments and stock business property or partnerships within zones so long as the assets are held for 5 years or longer. It would also include a business tax credit for hiring disadvantaged workers.

Fourth, it would give State and local governments the ability to request waivers to oppressive Federal regulations within the zones.

Fifth, it would create family development accounts to provide EITC recipients with a vehicle for enhanced personal savings.

Sixth, the bill would also include tax credits for commercial revitalization based on legislation that I introduced.

H.R. 2138, the Commercial Revitalization Tax Act, creates a tax credit that may be applied to construction, amounting to at least 25 percent of the basis of the property, which takes place in specially designated revitalization areas. Qualified taxpayers could choose a one-time 20-percent tax credit against the cost of new construction or rehabilitation.

Annually, the credit would be allocated to each of the States according to a formula that takes into account the number of localities where over half the people earn less than 60 percent of the area's median income. Localities would determine their priority projects and forward them to the State for allocation of credits according to an evaluation system which the States would establish. This would create a device for greenlining many of our downtowns in depressed communities.

Finally, title III of the American Community Renewal Act contains a provision that I will discuss and that I think is particularly important, a charitable tax credit. The legislation creates a non-refundable 75-percent tax credit for up to \$200 per taxpayer per year for donations to charities engaged in helping low-income Americans

To be eligible, charitable organizations must engage in activities generally aimed at assisting individuals who earn 185 percent of the poverty line or below, obtain their State tax-exempt status, and spend no more than 20 percent of their aggregate expenses on administration, fundraising, lobbying, and litigation.

Madam Chair, I firmly believe that the current laws discourage businesses from investing in urban areas and getting people out of the poverty trap. What we are hoping with this legislation is to provide a vehicle for providing incentives to rebuild our cities and revitalize neighborhoods.

I thank you for the opportunity to testify, and we certainly hope that this legislation will see the light of day some time in the near future to help many of our communities that most need it.

[The prepared statement follows:]

Testimony The Honorable Philip S. English before the House Ways and Means Subcommittee on Oversight July 16, 1996

Madam Chairwoman and Members of the Subcommittee, I want to thank you for holding this important hearing and for allowing me to address my colleagues and everyone in attendance today on the "American Community Renewal Act of 1996," H.R. 3467. This legislation, introduced by Representative J.C. Watts and Representative Jim Talent and forty-six others including myself will be examined much more closely at future hearings. Today, however, I want to focus on several specific tax provisions in the bill and how the implementation of these provisions relates to current law and disincentives for businesses to invest in urban areas.

The "American Community Renewal Act," is designed to revitalize families, neighborhoods, and business sectors in America's impoverished communities. H.R. 3467 will provide greater economic opportunities and new hope for millions of disenfranchised Americans trapped in poverty. It will do so by encouraging private-sector job creation in the community, providing opportunities for home ownership and bolstering private charitable activity, among other incentives.

Title I of the legislation builds on the enterprise zone legislation Jack Kemp offered in the 100th Congress. It includes the tax incentives in the Abraham-Leiberman bill in the Senate which contains legislation I introduced in the House, the "Commercial Revitalization Tax Credit Act," H.R. 2138, and the Riggs/English and Weldon bills in the House on empowerment zones. The purpose of Title I is to liberate the economic forces within disadvantaged communities by fostering an atmosphere where real private sector businesses and jobs are created. It recognizes that new and expanding small businesses are best suited to provide good jobs in urban neighborhoods. It comes from specific ideas that urban entrepreneurs believe are necessary to economically restore our low-wealth communities. Specifically, Title I would:

- Create 100 "Renewal Communities." To qualify, an area must have a poverty rate of 20 percent or more, an unemployment rate at least 1 1/2 times the national rate, and at least 70 percent of the households must bave incomes below 80 percent of the median income of households, and have had a population decline of 20 percent or more between 1980 and 1990.
- Require local communities to reduce tax rates and fees within zones and eliminate state and local taxes to be eligible for community designation.
- Require state and local governments to waive local occupational licensing regulations and other barriers to entry, except those explicitly needed to protect health and safety.
- Create substantial federal tax incentives for renewal communities including an elimination of capital gains taxes on investments in stock business property, or partnerships within zones so long as the assets are held for 5 years or longer. As well, the bill would include a business tax credit for hiring disadvantaged workers. (provisions from Riggs/English)

- Gives state and local governments the ability to request waivers to oppressive federal regulations within the zones. These regulations will be selected from those outlined by the Commission on Unfunded Mandates. (Riggs/English)
- Finally, the bill also includes tax credits for commercial revitalization based on legislation I introduced, the "Commercial Revitalization Tax Credit Act (CRTC)," H.R. 2138.

H.R. 2138 creates a tax credit that may be applied to construction, amounting to at least 25 percent of the basis of the property, which takes place in specially-designed revitalization areas, including enterprise communities, empowerment zones and other areas specially designated according to federal, state or local law. Qualified taxpayers could choose a one-time 20 percent tax credit against the cost of new construction or rehabilitation. Annually, the credit would be allocated to each of the states according to a formula that takes into account the number of localities where over half the people earn less than 60 percent of the area's median income. Localities would determine their priority projects and forward them to the state for allocation of credits according to an evaluation system which the states establish.

Title III of the "American Community Renewal Act" contains the final provision I will discuss today: a charitable tax credit. The legislation creates a non-refundable, 75 percent tax credit for up to \$200 per taxpayer/per year (\$400 for joint filers) for donations to charities engaged in helping low-income Americans. To be eligible, charitable organizations must: engage in activities generally aimed at assisting individuals who earn 185 percent of the poverty line or below; obtain their state tax-exempt status; and, spend no more than 20 percent of their aggregate expenses on administration, fund-raising, lobbying and litigation.

Madam Chairwoman, I firmly believe that current laws discourage businesses from investing in urban areas and, in fact, contribute to prolonging the poverty trap. Legislation like Reps. Talent and Watts have introduced is necessary to provide incentives to rebuild our cities.

Madam Chairwoman, this is not just a Republican solution. The ideas in this legislation have come from communities, and I believe they are good ideas that make sense. The "American Community Renewal Act" incorporates the ideas of the community leaders who already are making a difference. It is an aggressive urban policy that relies on the vitality of people while recognizing the limits and dangers of big government.

Thank you for the opportunity to testify.

Chairman JOHNSON. Thank you very much, Mr. English. Mr. Zimmer.

STATEMENT OF HON. DICK ZIMMER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW JERSEY

Mr. ZIMMER. Thank you, Madam Chair. I appreciate your having this hearing.

I have been interested in open space preservation for a number of years. When I was a freshman in the New Jersey State Assembly, I sponsored New Jersey's farmland preservation law, which has saved some 40,000 acres of land from development. That may not seem a lot to people from districts like Mr. Herger's and Mr. Laughlin's, but in New Jersey, which is the most densely populated State in the country, that is a pretty large piece of undeveloped land.

The first bill that I sponsored in this Congress that became law was one that would expand the boundaries of a national park in New Jersey, and the history of that property is worth noting, because it is what brought to my attention one of the problems of the Tax Code as it relates to the preservation of open space.

The New Jersey property in question had been owned by Sterling North who was a well-known 20th century novelist. After Mr. and Mrs. North died, their children could not afford to pay the estate taxes on the land, even though the Norths and their children and the National Park Service all wanted to include this land as part of the Morristown National Historical Park. So they had to sell their land

Fortunately, we were able, through a couple of bills that became law, to put this land into the National Park System. But it was a close call, and it might have been sold to a developer who would have taken it out of the potential ambit of the park forever.

This experience led me to introduce a bill specifically designed to encourage the donation of inherited property to the Federal Government. This legislation, which is pending before this Committee, is called the Open Space Acquisition and Preservation Act, and it allows heirs who donate real estate to the Federal Government to subtract the fair market value of this land from their estate taxes. It is narrowly drawn so that the land has to be undeveloped and it has to be sought for conservation purposes by a Federal agency such as the National Park Service.

I have introduced a second bill relating to open space that is pending before this Committee which was inspired by a practical problem encountered in the implementation of the New Jersey farmland preservation law that I referred to earlier.

This bill, the Land Preservation Tax Fairness Act, affects people who, in order to preserve open space, sell their land or a development easement in that land at below market value to a government entity or to a nonprofit organization.

In New Jersey specifically, our Farmland Preservation Program is so popular that there is not enough funding to pay full market value for the easements that are sold by farmland owners, so many of them are selling their easements at less than fair market value. When they do that, if they do it and realize a capital gain, which is the typical case, they end up paying a greater capital gains tax

than they would have if the sales price was actually fair market value.

They are paying twice, in effect. They are accepting less than the fair market value of the development easement, and then they are paying a greater capital gains tax on the sale, because it is considered to be a "bargain sale" under tax law, which means that the full value of the property's basis cannot be subtracted from the sales price. I can go through a hypothetical example of how that penalty would affect the typical seller, but I will do it only if asked in the question and answer period.

Basically, this legislation would treat more fairly people who have already decided to accept less than the fair market value that they could have accepted for the sale of their land or an interest in it. I think that is unfair, and it discourages the preservation of

open space.

Because donations and sales of undeveloped land are greatly influenced by tax treatment, these modest changes in the Tax Code could help to enhance open space preservation and assist in pro-

tecting America's heritage.

Madam Chair, you referred to the story of the flea on the elephant. The flea on the elephant sometimes can make the bridge shake a lot more than the elephant alone could. While I deeply hope that both my bills will become enacted into law, I must also underscore that they address only a small part of a larger problem, which is the bias of the Tax Code against preservation of open areas.

Current tax policies favor short-term investments in land development over long-term investments in open space preservation. Fairness should dictate tax policies that remove the current incentives to convert land to cash.

For instance, our Tax Code offers tax-exempt bond financing to businesses that build in empowerment zones but not those which purchase the land or the existing improvements in an empowerment zone. And, because the IRS levies estate taxes based on the value of a parcel's highest and best use, people often have to sell their land to a developer just to pay estate taxes.

According to American Forest magazine, most forest owners—and I am quoting now—most forest owners simply don't invest in maintaining their forests because tax policies make it almost impossible to deduct these costs on their tax returns. Instead, they extract some value by selling land fragments for development or cut-

ting some timber.

Fortunately, the motivation for many people is beyond economic gain, and most people who donate land for the purpose of open space preservation don't do it for financial benefit. But there are many others who simply can't afford to make such a donation or set their land aside because of punitive tax policies, and as the population of landowners grows older, this problem will only get worse. Open space will continue to be threatened unless we are able to correct the current imbalance in the Tax Code. It is not too late to address this problem, and I am glad that you have begun this process now.

I thank you, Madam Chair.
[The prepared statement follows:]

TESTIMONY OF THE HONORABLE DICK ZIMMER Ways and Means Oversight Subcommittee Hearing on the impact of the Federal tax law on land use July 16, 1996

Madam Chairwoman,

Thank you for your commitment to examining the impact of the U.S. tax code on the preservation of land.

This has been an issue of concern to me since I served in the New Jersey legislature. As an Assemblyman, I sponsored New Jersey's Farmland Preservation Act that has preserved more than 40,000 acres of open space from development. And the first bill of mine in Congress that became federal law involved open space and historic preservation -- a bill enabling the national park service to purchase a significant piece of property in new jersey adjacent to an existing 1,670 acre national park. The history of that property is worth noting, because it is what brought my attention initially to one way that the tax code can discourage our efforts to preserve open space.

The New Jersey property had been owned by Sterling North, the well-known 20th century novelist. After Sterling North and his wife, Gladys, died, his children were forced to sell the property to pay estate taxes. The National Park Service wanted the property as an addition to the Morristown National Historical Park, but North and his wife had not provided for such a donation in their wills, and their children could not afford to donate the land.

This experience led me to introduce a bill specifically designed to encourage the donation of inherited property to the federal government. The bill, which is pending before this committee, is called The Open Space Acquisition and Preservation Act, it allows heirs who donate real estate to the federal government to subtract the fair market value of the land from their estate taxes. The land has to be undeveloped and sought for conservation purposes by a federal agency, such as the National Park Service.

I have introduced a second land preservation bill which was inspired by a practical problem encountered in the implementation of my farm preservation law. That

bill -- The Land Preservation and Tax Fairness Act -- affects people who, in order to preserve open space, sell their land or a development easement at below market value to a government entity or a nonprofit organization. Federal tax policy does not treat the gain from such sales fairly. The taxable gain from a "bargain sale" is calculated by subtracting only a fraction of the property's basis from the sales price, so the benefactor cannot receive the tax benefit that adequately reflects the original expense of purchasing the land.

For example, if land, purchased years ago for \$200,000, and now worth one million dollars, is sold to a charitable organization for \$500,000, the taxable gain would be calculated by subtracting just one half the original cost of the property --\$100,000 -- from the selling price of \$500,000. In this case, the benefactor would not only forgo the additional \$500,000 he would receive if he had sold it at its true value, but would also find his taxes increased by \$28,000 (that is, 28% of \$100,000), because of the impact of this rule. Clearly, the current system discourages charitable land preservation transactions.

My bill would amend the tax code so that the taxable gains from this kind of "bargain sale" would be calculated by subtracting the full basis from the selling price. Under my proposal, the individual in the hypothetical example could subtract \$200,000 from the sale price of \$500,000 lowering the net taxable gain to \$300,000, instead of \$400,000.

Because donations and sales of undeveloped land are greatly influenced by tax treatment, these modest changes in the tax code could help to enhance open space preservation and assist in protecting America's heritage.

While I deeply hope that both of my bills will become law, I also must underscore that they address only a small part of a larger problem, which is the bias of the tax code against preservation of open areas.

Current tax policies favor short-term investments in land development over longterm investment in open space preservation. Fairness should dictate tax policies that remove the current incentives to convert land to cash.

For instance, our tax code offers tax-exempt bond financing to businesses that **build** in empowerment zones -- not to purchase the land or the existing improvements -- but only to build.

And, because the IRS levies estate taxes based on the value of a parcel's "highest and best use," people often have to sell their land to a developer just to pay the estate taxes.

According to the American Forest's magazine, "most forest owners simply don't invest in maintaining their forest because tax policies make it almost impossible to deduct these costs on their tax returns. Instead they extract some value ... by selling land fragments for development or cutting some timber."

Luckily the motivation for some out there is beyond economic gain. Most people who donate land for the purpose of open space preservation don't do it for financial benefits. But there are many others who can't afford to because of punitive tax policies.

And as the population of land owners grows older this problem will only get worse.

Stephen Small, a Boston attorney and probably the leading authority on land preservation and the tax code, points out that an enormous amount of private land in this country is held by people who are 55 years and older, which means that over the next 15 to 20 years, millions of acres are going to change hands and potentially change use, depending on how landowners plan for their land's future.

Open space will continue to be threatened unless we are able to correct the current imbalance in the tax code.

I believe it is not too late to address this problem.

The process must begin now.

Thank you.

Chairman Johnson. I thank you all for your thoughtful testimony and for your legislative initiatives, and I believe that this Committee has given too little attention to how tax policy affects matters in both rural and urban areas.

A number of you have talked about changing the Tax Code to make it easier to preserve land for conservation or to develop easements across land. In looking at those issues, have any of you looked at the IRS' requirement that we value parcels at their highest and best use?

One of the possibilities would be to require the IRS to value land at its current use if its current use is going to continue, and only when its use changes, to then tax accordingly. Have any of you looked into that or have any reason to believe that that would be—

Mr. HOUGHTON. Well, Madam Chairman, I think that is really the basic thrust of the bill which Mr. Payne and I are suggesting. Rather than forcing our land to be at the highest and best value, which many times is in development of housing or things like that, that the tax, if sold, would be based on current use, which is not the case now.

Chairman JOHNSON. Thank you, Mr. Houghton. I wasn't clear on that from your testimony, whether that is the way your bill operates.

Mr. Payne. Let me just, I guess, reiterate what Amo has said, and that is that for estate tax purposes, when someone has placed their land in a conservation easement and when that easement is approved, then the purpose is that the value of the property would not be the highest investor use, that is, in the example I mentioned in Philadelphia, as a developed property, but, rather, that they would carry forward the basis of the property that they would currently have in lieu of that. That then would provide the kind of relief that they would need to be able to continue to provide this as open space or allow that conservation easement to actually work. But that is an integral part of making this bill a viable and workable bill.

Chairman JOHNSON. Are conservation easements broad enough? When you put something under a conservation easement, can you continue to farm it?

Mr. ZIMMER. In New Jersey, you can. That is the essence of the farmland preservation legislation. The easement is sold to a county agriculture development board.

In theory, it should be sold for the difference between the fair market value of the land and the land's value as restricted to agriculture, along with a residence that would be on the agricultural parcel. And then from then on, there is a restriction recorded with the deed which says that the land can be used only for farming, and that is the restriction of perpetuity. But the point is to restrict it for that purpose.

Other conservation easements can be crafted to reflect the purpose for which the conservation easement has been given; for instance, the protection of flood plain along a stream or other natural areas.

Chairman JOHNSON. But these are generally given, not purchased, like development rights?

Mr. ZIMMER. Well, as I said, in New Jersey they are purchased, but they can be donated as well.

Chairman JOHNSON. And under your bill, Mr. Houghton and Mr.

Payne, they would be donated?

Mr. PAYNE. We would generally anticipate that they would be donated. It seems that there is a lot of interest of people now in doing this and donating, except for the fact that they run into this estate

tax problem.

If we could find a way to, such as the requirements of our bill—if we could find a way to ensure that we can alleviate estate tax problems, I think there would be a considerable amount of land that might well be considered for conservation on a voluntary basis, which is why the elements of this bill are attractive. It does not require the governmental unit, whether it is the county or the State or the Federal Government, to actually purchase these, it achieves the same purpose, but it does it through the estate Tax Code.

Chairman JOHNSON. States are tending to run out of their development dollars that they have allocated in the past to the purchase of development rights.

Current law does require that family farms and real property used in closely held businesses can be included in estates at their

current use value.

Have you found that the closely held business requirement is too narrow to help farmers who are trying to pass their land on to their kids for continued farm use?

Mr. PAYNE. There seem to be several concerns about that, and it does not seem to be providing the kind of incentive that we ought to provide. One, of course, is that it is capped at \$750,000, and in the case of many larger farms that may not be sufficient.

Second, it is a program that requires that, beyond the event of death or when the estate transfers, that for some period of time that the same use continues—I think it is 10 years—and during that period of time, the Federal Government would have a lien on the property, which makes it very difficult then to borrow money to continue to operate in that regard.

There are requirements in terms of ownership prior to and after the estate changes hands, and I think all of those things add to some complexity that makes it generally not a very effective way of encouraging people to maintain their land and conservation easements.

Chairman JOHNSON. Thank you. That was very helpful.

Clay, on your proposal, to what extent does your bill reinstate the pre-1986 provisions of the historic preservation tax credit?

Mr. Shaw. I am not sure exactly what the details were in the 1986 provisions. I know that throughout the country, though, that the tax incentive that was in the law back then did a tremendous job for us across the country in historic preservation, but I am not sure exactly whether we tracked that law exactly or not with regard to the 20-percent tax credit.

I have been told that the pre-1986 law was for commercial property and this one is for homeowners. This is limited to homes. This does not get into the commercial side of things.

Chairman JOHNSON. Interesting. Thank you very much.

It seems to have enormous relevance to a city like Chicago where there are whole beautiful graystone shells.

Mr. SHAW. We also have an estimate from Joint Tax of \$239 million over the 5 years.

Chairman JOHNSON. \$239 million?

Mr. Shaw. It is less than what I thought it would have been.

Chairman JOHNSON. Thank you very much.

Mr. English, I thought you and your colleagues came up with some very good ideas, some of which could be applied without the enterprise zone concept behind them. Isn't that true?

Mr. ENGLISH. That is correct.

Chairman JOHNSON. I would have to say that in Connecticut, where we have developed the enterprise zone now quite radically in the last couple of years, there is developing a terrible tension among towns that got an enterprise zone and those that didn't and an imbalance in their ability to attract small industry, which they all need. So there are some problems with that.

I like the way you structured part of the tax credits in your bill. It really looked at the kind of indicators that directs those credits

and places a preference.

I also liked the right of the State to direct the credits. This is what is now happening in the Low-Income Housing Tax Credit Program. Estates are setting the priorities as to where those projects ought to be directed, and it has been very fruitful.

Mr. Herger.

Mr. HERGER. I don't have any questions.

Mr. Shaw. Madam Chairman, can I insert something here, because I think it is tremendously important with regard to your comments to Mr. English.

Chairman JOHNSON. Yes.

Mr. Shaw. In the Human Resources Subcommittee, we are going to be taking a very close look at the inner cities' enterprise zones and different things that we are going to have to do in order to wean this country off of the present stagnant welfare system that we have. Perhaps you as Chairman of this Committee and I as Chairman of the Human Resources Subcommittee, perhaps at some future date we should look to have some joint hearings in order to explore more and more possibilities of how to work our way out of the current corrupt welfare system.

Chairman JOHNSON. I think that would be very useful, because one of the issues is going to be affordable housing in the cities, housing that is affordable fundamentally, not because of section 8 vouchers and things like that. So we really have a lot of work to do in that area, and I look forward to doing that with you.

Mr. Ramstad.

Mr. RAMSTAD. Thank you, Madam Chairwoman, and thank you for calling this important hearing today and for your leadership in this area. I truly believe this is an important hearing, and I applaud the leadership as well of our colleagues who are testifying in this first panel today.

I have long believed that the Tax Code should be used to meet land use objectives in general and to encourage environmental protection in particular. I am very interested in exploring, in these and other ways, how we can use tax incentives to encourage greater environmental protection, greater conservation.

I would like to focus on your bill, Mr. Houghton, which I think is an excellent piece of legislation. I am wondering if your bill limits tax benefits only to conservation of easements of farmland, or would other types of conservation easements be eligible as well?

Mr. HOUGHTON. No. It really is just real property, farmland and

ranch property.

Mr. RAMSTAD. So it doesn't extend to other types of conservation easements.

Mr. HOUGHTON. No.

Mr. RAMSTAD. Also, why does your bill limit tax relief to land within a 50-mile radius of a metropolitan area? Why do you place that limitation?

Mr. PAYNE. Could I speak to that?

Mr. HOUGHTON. Sure, you bet.

Mr. RAMSTAD. You are a cosponsor, Mr. Payne, and I should recognize your efforts as well.

Mr. PAYNE. Thank you, Jim.

The intent here was to look to see what might be done reasonably, within reasonable cost limitations, to begin to find ways to protect important open spaces, and it really is a matter of economics. If, in fact, we had the whole country that was going to be taken in under this legislation, the cost of it would be much more than we thought would be affordable in this climate.

This bill, as it was last looked at by the Joint Tax Committee, with certain modifications, showed it had a cost of \$781 million over 5 years. It was a more limited provision of this that actually was in the Balanced Budget Act that was passed by the House and the Senate that would have had a cost of \$340 million over 7 years. This is not only in the areas of SMSAs or metropolitan areas within 50 miles, but also national parks as well, recognizing that they are already national treasures and we would be interested in looking at how they might be properly protected as well.

Mr. RAMSTAD. So the fiscal impact is what limited that applica-

tion.

Mr. HOUGHTON. Yes.

If I could just add the difference in the cost between the provision and the balanced budget agreement, and this has to do with the radius, which is 50 miles in some areas and 25 in others.

Mr. RAMSTAD. I appreciate that clarification.

Mr. PAYNE. It is two things. First, it is fiscal, but second, it is looking at those areas that are most in need of some sort of easement or some sort of conservation. Otherwise, they will be developed in the very near future and we will never have an opportunity to conserve some of these areas for future generations.

Mr. RAMSTAD. Well, thank you again, gentlemen. And thank you,

Madam Chairwoman.

Chairman JOHNSON. If the gentleman would yield on that, I wasn't quite clear on your response in terms of the difference between the Balanced Budget Act version of your bill and your bill. Is the primary difference that 25-mile radius as opposed to the 50-mile radius?

Mr. HOUGHTON. The primary dollar impact is.

Mr. PAYNE. I think it was a more limited version in that it was limited geographically. It is also limited in terms of the percentage of the estate that must fall into this category, which further limits

and to some extent is somewhat problematic.

We think that ours is a better public policy and we would want to continue to work with the bill that we have, recognizing, though, that the concept has been approved by both the House and the Senate and that there are some things that could be done to modify it to make it a very good piece of legislation, we think.

Chairman JOHNSON. What is the limit on the percent of the es-

tate that can be included?

Mr. PAYNE. The limit is 40 percent.

Chairman JOHNSON. So that functions like the \$750,000 cap in current law.

Mr. PAYNE. It does. It becomes a limiting factor in terms of who would qualify for this particular provision. It is not necessarily on which pieces of land that most need to be protected or conserved but, rather, a percentage, an economic percentage of the estate is the criterion.

Chairman JOHNSON. Thank you.

Mr. Laughlin.

Mr. LAUGHLIN. Thank you, Madam Chairwoman, for calling this hearing. I thank all of my colleagues for the hard work they have

done. It is important.

With all of you, the basic concern I have is, it sounds like you want to transfer title to all of this property to the Federal Government. I have a real problem with that, because in my State, we are a State where the Federal Government purchased or had donated all of the property, and I have an experience in my own district where substantial land has been taken off the local tax rolls.

It occurs to me also that the private landowner also has equal, and many times superior, capability to take care of this property

than the Federal Government.

Is there a reason why we are transferring title, even when we are calling them conservation easements? Do any of the bills allow it to take place without transferring title from the landowner?

Mr. PAYNE. We are not talking about transferring the title, we are talking about providing an easement so that the title is maintained, private landowners continue to own their land. This provides them, though, the ability to do with their land what they would like to do, such as in the case that I had just mentioned where someone who wants to be able to continue to farm their land won't be able to do that when the estate passes, because the taxes will be so high, they will have to sell that.

This provides a way that we can allow that private property owner to do precisely with their property what they would like to

do.

Mr. LAUGHLIN. Does yours and Amo's bill allow a family to continue farming without having a tax consequence just because the father or the grandfather or the grandmother has passed away?

Mr. PAYNE. That is precisely what this bill is attempting to do. Mr. LAUGHLIN. Well, I like the thrust of your bill. But let me tell you a problem I have with your 50-mile radius and your national park provision.

As Mr. Zimmer accurately observed in his opening statement, not only Mr. Herger and I, but there are a number of other Members who have substantially large geographic districts, and they go way beyond this 50-mile radius from an MSA.

The concern I have is, just using the 14th District of Texas that I represent as an example, most of it is more than 50 miles from an MSA. But we have at least two interstates that go through my district, and within a short distance of every inch of that interstate the real estate values are unreasonably high because of developers and speculation, and you go 500 yards away, and the property drops in value substantially.

So I have a real problem with that 50-mile radius not taking into consideration some other factors, and then when you look at the national parks, there is not a national park that I am aware of within 50 miles of the 14th District, yet there are seven wildlife refuges within the district I represent, and those have as much value to the citizens and the Nation, and probably more value on the wildlife side, than the national parks do, yet we are not taking those into consideration, and in some of these the landowner has some restrictions.

So I would certainly ask you to consider adding wildlife refuges, because these are all under the control of the Federal Government. But I wonder how you would address this 50-mile phenomenon, and I know it is an arbitrary figure at this point, recognizing these interstates, and there is probably some other examples that artificially inflate the dollar value on ranch- and farmland.

Mr. PAYNE. Greg, I understand that in your district between San Antonio and Victoria—

Mr. LAUGHLIN. San Antonio and Houston, to give two large metropolitan areas, and that is 200 miles, so you come out—

Mr. PAYNE. It is not only the larger metropolitan areas. I understand that in your district, a substantial part of your district is covered by this, which I assume is one of the reasons that you are a cosponsor of this legislation. While I think it would be perhaps positive if we could find ways to expand its definition, one of the considerations is the cost, and the more we expand the definition, the more difficult it is to enact this legislation, as we have worked at it for several years.

But we would like very much to continue to work with you to find ways to accommodate the kinds of things that you have just mentioned.

Mr. LAUGHLIN. Well, that is the point I was making. I like the thrust of all of the bills, but sitting here listening to you, I have that concern that I mentioned.

Mr. Zimmer, I commend you for your legislation and certainly you are addressing issues that are important outside of the metropolitan areas, and particularly in districts that have a lot of farmland and ranchland.

The concern I have—and I would wish you to address it specifically in your bill—as I understand it, in every instance the land-owner, to preserve that property for a well-intended use, must either sell or donate the property to the Federal Government. And if that is the case, why have you not considered the State govern-

ment, in which in many instances our States have some very fine conservation programs within the State, or even local government?

And last, I would like for you to address the option of giving the easement and letting the landowner retain title, and in the instance of my State, they would be paying State and local taxes.

Mr. ZIMMER. There are two separate bills I have referred to. One deals not with easements but with title to the land, and that bill relates to the Federal Government. The other deals with easements but not transfers to the Federal Government.

The first one is basically designed to avoid all of the transactional costs involved in the transfer of inherited land to the National Park Service or the Fish and Wildlife Service or whichever Federal agency was intending to purchase the land in the first place. This has to be land that was already identified for acquisition and would have been bought with appropriated funds through either a negotiated sale or eminent domain by the Federal Government.

Under current law, the land goes to the heirs, the heirs pay the estate tax, and then whoever owns the land afterward sells it to the Federal Government in a process that costs more money than the simple credit arrangement that I would substitute for it. We would short circuit all of this and allow the heirs to transfer the land in lieu of the same value of dollars to the Federal Government in satisfaction of the estate tax burden.

So it doesn't expand the ownership of land by the Federal Government any more than what was intended in the first place; it simply makes it a short-circuit process rather than a convoluted, expensive one that may actually cost the taxpayers as well as the heirs more money.

The second bill contemplates the sale of an easement to a private conservation organization or typically a State or local government. It could involve, in theory, a sale to the Federal Government, but that was not what I had contemplated, because it was suggested to me as a result of the actual implementation of New Jersey's farmland preservation law, which involves the purchase of conservation easements by a county agricultural development board which is funded in part by the State, if those easements are purchased at fair market value, you pay the capital gains tax on the amount that you received, and there is no problem.

However, we have begun to run out of money, as the Chair pointed out was the case in Connecticut, for the purchase of as many easements as are for sale. So there are many landowners, out of a combination of necessity and philanthropic impulse, who are selling their easements at less than the fair market value.

When that is the case, it is categorized under a generic category in the tax law as a bargain sale, and you would end up paying a higher capital gains tax than would ordinarily be the case. That is unfair. It is a double hit on somebody who is taking less than fair market value, but it doesn't expand the ownership of land by the Federal Government.

Mr. LAUGHLIN. Under either of your bills, can a family pass on farmland?

Mr. ZIMMER. Both—well, the first bill is intended to transfer ownership of farmland, or whatever kind of land it is to the Fed-

eral Government. The second bill is designed to encourage a system which continues private ownership of land, and in New Jersey, at least, the taxes paid by that landowner are in no way diminished once the easement is sold, because our farmland is typically taxed at its agricultural value, not at its highest and best use for property tax purposes.

So there is no diminishment of property tax revenue to the local government, and, as I said, the land is owned—subject to the deed restriction—by the family. The family can will it to its heirs or it can sell it to another landowner who will buy it subject to the ease-

ment.

Mr. LAUGHLIN. Madam Chairman, I have taken enough time, but I think all of this truly points out why we need some tax reform passed by our Congress.

Chairman JOHNSON. I think your questions do point directly to that, and the quality of this panel's thinking on this subject not only bespeaks the urgency that Members feel about this but also

the amount of work that has been done on it.

Mr. Laughlin. Well, it also points out that the danger is maybe not to the generation of anybody on the panel or sitting up here looking down at Mr. Shaw, but it certainly will be to my grand-children—and I have none at this stage, but my grandchildren's generation. How are they going to have ownership of any real estate to farm and ranch to help clothe and feed our citizens, 75, 100 years from now? I think this is a very important question for this Committee to consider, and I commend everybody on this panel for the important work you have done in that direction.

Chairman JOHNSON. Yes. I thank you, and I thank the panel

verv much.

I think one of the things we need to think about is that, as we constrain costs, we also create inequitable rights across the Nation, and we have to be very careful about that, and we may need to fight for a bigger package so that we have the same rights for people in a lot of different circumstances.

Mr. Pavne.

Mr. PAYNE. Madam Chairman, before we leave, one of the people who will testify on the next panel is one of my constituents, Tim Lindstrom, who is testifying on behalf of the Piedmont Environmental Council. Tim is a very thoughtful person. The Piedmont Environmental Council is a very thoughtful conservation group, and I am pleased that they are able to be here to talk about our bill today.

Thank you.

Chairman JOHNSON. Thank you very much. I thank the panel for their excellent testimony.

The next panel will consist of Tim Lindstrom, Charlottesville office of the Piedmont Environmental Council, Charlottesville, Virginia; Jean Hocker, the president of the Land Trust Alliance from Washington, DC; and Irv Bell, the president of the Ohio Farm Bureau Federation, on behalf of the American Farm Bureau Federation.

Mr. ZIMMER [presiding]. Mr. Lindstrom, can you begin with your testimony, please.

STATEMENT OF C. TIMOTHY LINDSTROM, DIRECTOR AND STAFF ATTORNEY, CHARLOTTESVILLE OFFICE, PIEDMONT ENVIRONMENTAL COUNCIL, CHARLOTTESVILLE, VIRGINIA

Mr. LINDSTROM. Thank you, Mr. Zimmer and Members of the Subcommittee, for the opportunity to speak today.

My name is Tim Lindstrom, and I am an attorney with over 24 years of experience in estate tax, land use, and conservation law. I currently serve as an attorney with the Piedmont Environmental Council.

The Piedmont Environmental Council is a not-for-profit land conservation organization working in the northern Piedmont region of Virginia. We have extensive experience with conservation easements. We became involved in this legislation which Congressman Houghton and Congressman Payne described as the American Farm Protection Act back in the 101st Congress when Congressman Schulze first introduced it as the Open Space Land Act, and I would like to thank Mrs. Johnson for being one of the original cosponsors way back in the 101st Congress and sticking with it ever since.

Congressman Schulze became interested in this issue because he had constituents who were being forced out of farming by Federal estate tax on farmland ranging in value from \$20,000 to \$40,000 an acre. We became involved because of that concern, and because our experience with conservation easements convinced us that a more predictable and compelling incentive was needed for voluntary land conservation. It was to address these two goals, estate tax relief and providing a more compelling and clear incentive for land conservation, that this legislation was introduced.

While the Virginia Piedmont is characterized by dramatically inflating land values and urban sprawl, that certainly isn't a feature confined to the Virginia Piedmont. In fact, during the eighties, just to take one example, while the population of the State of Michigan grew by 33,000 people, which isn't very much, the amount of land consumed for urban and suburban uses in that same period of time

increased by 40 percent.

A 1995 review of the USDA census of agriculture for the congressional districts which were then represented on the Ways and Means Committee showed that nearly 4 million acres of actively farmed land had been lost in just those districts alone since 1974. That is a loss of over 20,000 farms.

During the same period, the average value per acre of farmland in these districts increased by nearly 200 percent, so that nearly 26,000 farms just in these districts were exposed to potential Federal estate tax. In Mrs. Johnson's district alone, values since 1974 have increased by 280 percent, so that the average farm in her district is now worth \$670,000.

As a 12-year veteran of the Albemarle County Board of Supervisors in Virginia, I know of the political and legal difficulties involved in trying to regulate the effective protection of farmland and open space. I also know that the cost of protecting land by outright purchase is prohibitive. That is why we support the American Farm Protection Act. We believe it is a very practical approach to protecting rural land under development pressure. It is voluntary; it does not involve government regulation; it does not involve the

cost of acquisition or maintenance of land.

While I recognize that the special use evaluation section of the Federal Tax Code, section 2032A, is designed to relieve farmers of the burden of estate taxes, in our experience, it has not been effective. Section 2032A is complex and difficult to qualify for. In addition, as Mr. Payne mentioned, there is a limit on the amount of tax savings allowed which has not been adjusted for a number of years, and a Federal tax lien is imposed on the farm for the duration of the agreement that is required under 2032A, and that tax lien significantly interferes with the farmer's ability to obtain operation and expansion loans. There is also no incentive in section 2032A for long-term voluntary protection of land.

The proposals which were introduced in this Congress to improve section 2032A as well as section 6166, which provides for installment payments of estate tax on certain farmland, will help a little bit. However, none of the proposed changes significantly improve the provisions of these sections which most discourage their use, and none of them provide an incentive for permanent, voluntary

land conservation.

Current law allows a deduction for the value of conservation easements which have been donated. However, because the valuation process is very unpredictable, the extent of potential estate tax liability on land restricted by an easement is also uncertain, and that is a disincentive for people who are interested in conserving their land with that tool.

Current tax treatment of easement donations also tends to favor those who have large incomes and can take advantage of the income tax deduction under section 170(h). On the other hand, those who have little income but very valuable land, which is the case with many farmers, can find little tax advantage to donating an easement under the current law.

The American Farm Protection Act avoids all of these problems and provides simple, predictable, and effective estate tax relief as well as a compelling new incentive for voluntary land conservation. We thank you for your past support of this legislation and urge you to include it in any legislation moving through the Committee.

Thank you very much.

[The prepared statement follows:]

STATEMENT BEFORE THE SUBCOMMITTEE ON OVERSIGHT COMMITTEE ON WAYS AND MEANS ON BEHALF OF THE PIEDMONT ENVIRONMENTAL COUNCIL BY C. TIMOTHY LINDSTROM JULY 16, 1996

Thank you, Madam Chairman, and members of the Subcommittee for giving me this opportunity to speak to you today regarding the impact of federal tax law on land use in the United States. My name is Tim Lindstrom, and I am an attorney with over 24 years of experience in estate tax, land use, and conservation law. I currently serve as staff attorney to the Piedmont Environmental Council.

The Piedmont Environmental Council (PEC) is a not-for-profit land conservation organization working in the Northern Piedmont region of Virginia. We have worked with land owners for over 20 years advising them on estate tax matters and encouraging them to take steps to conserve their land - primarily through conservation easements. We have extensive experience with conservation easements. I should add that the PEC itself does not hold any easements because Virginia has a very excellent state agency, the Virginia Outdoors Foundation, which holds most of the conservation easements in Virginia.

The PEC became involved in H.R. 864, the legislation now known as the American Farm Protection Act, when Congressman Richard Schulze first introduced it in the $101^{\rm st}$ Congress as the Open Space Land Act. I would like to thank the Chairman, Mrs. Johnson, for being a co-sponsor of this legislation ever since it was first proposed by Congressman Schulze.

Congressman Schulze became interested in this issue because he had constituents who were being forced out of farming by federal estate tax on farmland ranging in value from \$20,000 to \$40,000 an acre. We became involved because of that concern, and because our experience with conservation easements convinced us that a more predictable and compelling incentive was needed if voluntary land conservation were to become a significant source of land conservation in the United States. It was to address these two goals: estate tax relief for the owners of rural land and the provision of a stronger incentive for voluntary land conservation, that this legislation was introduced.

The Piedmont region of Virginia, like many urbanizing areas, is characterized by dramatically inflating real estate values. Farmland which once sold for \$500 an acre in the 1960s now sells for \$10,000 to \$15,000 an acre. It is also characterized in many counties by intense pressure for development which sprawls across open country at low densities, wasting land and further increasing the pressure for farm conversion.

Loss of farmland and sprawl is, of course, not limited to Virginia. During the 1980s, for example, while the population of the state of Michigan grew by only 33,000 people, developed land area increased by over 40%. A 1995

review of the USDA Census of Agriculture for the 32 Congressional Districts then represented on the Ways and Means Committee showed that nearly 4 million acres of actively farmed land had been lost in those districts alone since 1974. This represents over 20,000 farms. During the same period the average value per acre of farmland increased by nearly 200% so that nearly 26,000 farms were exposed to the federal estate tax in those districts. In Mrs. Johnson's district alone values have increased by 280% since 1974 and nearly 46,000 acres have been lost to farming. In 1992 the average farm value in Mrs. Johnson's district was \$670,000.

As a 12 year veteran of the Albemarle County Board of Supervisors in Virginia, I am personally aware of the legal and political difficulties involved in trying to regulate the effective protection of farm land and open space. I also know that, while the purchase of development rights has an important role to play in protecting farm land and open space, the cost of these programs prohibits their being applied on the broad scale needed to protect a meaningful base of open land.

That is why we support the American Farm Protection Act. We believe that it is a very practical approach to protecting farm land and other land of conservation value that is under development pressure. It is voluntary and does not involve government regulation. It also avoids the huge costs of acquisition which include taking land off local tax rolls and requirements for maintenance.

Current estate tax law contains three provisions which are relevant to the protection of rural land. Section 2032A, which provides for special use valuation of certain farmland, ranch land and forest land; Section 6166, which allows certain estates containing farm or ranch assets to pay estates taxes in installments; and Section 2055, which allows a deduction for a testamentary bequest of a "qualified conservation contribution" as defined in Section 170(h) of the Internal Revenue Code of 1986. (A "qualified conservation contribution" is a conservation easement.) In addition, land subject to a "qualified conservation contribution" donated during a decedent's lifetime will be valued for estate tax purposes by taking into consideration the extent to which the conservation easement reduces the value of the land in the decedent's estate.

The problem is that these provisions of the current law are not effective. They are far too complex to be practical and too limited to provide effective relief. The provisions directed at conservation easements are too unpredictable in their effect and also too limited to provide a real incentive for voluntary land conservation.

A 1981 Government Accounting Office (GAO) study of Section 2032A concluded that "...special use valuation is difficult to administer and comply with, its complexity has tended to restrict its use to wealthy estates..." More recently, in her statement to the Senate Finance Committee on June 7 of last year, Deputy Assistant Treasury Secretary Cynthia Beerbower reported that she had informally surveyed practitioners and others familiar with the difficulties facing farmers and other family businesses and found that both Sections 2032A and 6166 were complex and difficult to utilize.

Surveys of federal estate tax returns filed between 1989 and 1991 indicate that an average of less than 3,500 estates elected treatment under Section 2032A; that is only 7% of all returns filed annually.

There are a number of reasons why Section 2032A is so little used. It is complex and difficult to qualify for; there is a limit on the amount of tax savings allowed, which has not been adjusted for a number of years; in order to qualify, all owners of land selected for Section 2032A treatment must consent to personal liability for deferred taxes; a federal tax lien is imposed which significantly interferes with the ability to obtain operating and expansion loans; and a number of other requirements also pertain. In addition, Section 2032A is not applicable to a considerable amount of land that is important because of its environmental sensitivity or proximity to national parks or wilderness areas. There is also no incentive in Section 2032A for the long-term voluntary protection of the land. In fact, the donation of a conservation easement on land subject to a Section 2032A election has been found by the Tax Court to violate requirements of this Section and trigger a recapture of tax savings.

Section 6166 applies only in certain circumstances, which will often preclude relief for estates holding land with publicly important conservation values. Even where it applies it leaves farm families with a continuing annual obligation which must be secured by a federal tax lien on the farm and which must compete with the many other economic demands on what may be a very limited income. Furthermore, like Section 2032A, Section 6166 provides no incentive for long-term voluntary land conservation.

Current law also allows a deduction (or, in the case of inter-vivos easement gifts, a reduction in estate value) for the value of conservation easements. However, the extent of the deduction and therefore the extent of remaining tax liability on the restricted land is unpredictable. This tends to discourage prospective donors who fear the easement may limit their heirs ability to sell land to pay the tax.

Current tax treatment of conservation easements also tends to favor those who have large incomes and can take advantage of the income tax deduction. On the other hand, those with very valuable land but small incomes find little advantage from donating an easement. Many farmers and ranchers fall into this category. For them the current tax benefits of easement donation provide little or no incentive. In addition, valuation of the easement is constantly challenged by the IRS in some parts of the country — a factor which has discouraged more than a few potential donors.

The American Farm Protection Act offers simple, predictable and effective relief and a compelling incentive for voluntary conservation to owners of land with publicly significant conservation value that is under development pressure. It does so by providing a full exemption from estate tax for land subject to a conservation easement meeting the existing standards of Section 170(h) of the Internal Revenue Code of 1986. We thank you for your past support of this legislation and urge you to include it in any legislation which may come before the Committee.

Chairman JOHNSON. Thank you very much, Mr. Lindstrom. Ms. Hocker.

STATEMENT OF JEAN HOCKER, PRESIDENT, LAND TRUST ALLIANCE, WASHINGTON, DC

Ms. HOCKER. Madam Chair and Members of the Committee, I thank you a great deal for devoting your time and attention to this really important issue. I also want to thank Congressmen Zimmer and Houghton and Payne for your leadership in advocating new

legislation to encourage private voluntary land conservation.

I am president of the Land Trust Alliance. It is a national non-profit umbrella organization that provides services and assistance to the Nation's more than 1,100 land conservation organizations known as land trusts. Madam Chair, in your State alone, there are over 100 of these land trust organizations. In New Jersey, the New Jersey Conservation Foundation and many smaller groups have protected a great deal of land. I am happy to say that there are new land trusts forming now in Texas, and so we are seeing this movement of private voluntary land conservation groups spreading all across the country.

These groups usually serve a single community, a watershed, a valley, or other defined region, and their purpose is to work with landowners to protect, through voluntary means, natural areas, productive forest- and farmland, habitat, urban gardens, trails,

greenways, and all kinds of open land.

Land trusts use many tools. They acquire and manage land for conservation, and very often they use the conservation easement, which is a tool we have talked about and heard a lot about this morning. It is sometimes a little difficult to understand how easements work, but basically they are legal deed restrictions on the future use of land. The restrictions protect the conservation values of the land while leaving the land in private ownership on tax rolls and in productive use. It is an extremely useful tool for voluntary land conservation.

What I want to do today is to describe not just one incentive but several incentives for encouraging private voluntary land conservation. First I want to say just a couple of words about why it is important for the Congress of the United States to enact new incentives.

Sound land use requires a mix of land that is built on and land that is not built on. Undeveloped land near where people live used to be easy to find because no one had gotten to that land yet. We all remember the vacant lots where we all played as a kid or the hillsides defined at the edge of town or down the block where you could watch tadpoles become frogs. People don't find that any more.

We need to take deliberate steps to ensure that there is some open space left. We need to plan for open space, because open land once built on will never again, in at least one human's timeframe, become available as open space. It is disappearing, and we are not going to get it back.

Land trusts are showing over and over in every State that many property owners do want to protect their land in a relatively undeveloped state, and they will do that voluntarily if they know how and if they have any incentives to do so.

As my written testimony points out, there are already incentives in the Tax Code for donations of land and gifts of conservation easements. No landowner that I know has protected land solely because of tax benefits. If there is a market for development, it is always, always more lucrative to develop the land. But the incentive is to help tip the balance for those landowners who have a conservation ethic, and provide tax incentives to encourage land protection at a public cost far lower than public land acquisition and management.

My written testimony addresses six new incentives for private voluntary land conservation. Some are significant changes. At least one is a minor adjustment to correct an existing impediment to

easement gifts.

First, I would urge Congress to enact the American Farm Protection Act that is sponsored by Congressman Houghton and which Tim Lindstrom and others have talked about and will talk about more.

I would urge you to enact legislation advocated by Congressman Zimmer to permit an executor to donate land or a conservation easement as a credit against estate taxes, a very important issue to enable the heirs to make decisions that the decedent perhaps didn't make or was unable to make.

Enact also Congressman Zimmer's proposal to change the way land is calculated in order to encourage more below-market-rate sales.

Make tax incentives apply to people of modest income by increasing the percentage of income that can be deducted in any tax year

for gifts of appreciated land or easements for conservation.

Change the current Tax Code provision that inhibits donations of conservation easements on land with severed mineral rights. This is a very little-known provision that is holding up a lot of easement donations, donations of people who would like to protect their land with conservation easements and cannot do it because of the provision on severed mineral rights.

And explore incentives to encourage good conservation manage-

ment practices on private lands.

All of these proposals are consistent with a chapter I wrote in a book called "Land Use In America," which I would like to make available to the Committee. We also offer you our assistance in learning more about how conservation easements work, because we have done a good deal of work on that as well and have literature on it. We are pleased to make our assistance available.

Thank you, Madam Chair.

[The prepared statement follows:]

STATEMENT OF Jean Hocker PRESIDENT LAND TRUST ALLIANCE

SUBMITTED TO THE

SUBCOMMITTEE ON OVERSIGHT COMMITTEE ON WAYS AND MEANS UNITED STATES HOUSE OF REPRESENTATIVES

Hearing on the Impact of Tax Law on Land Use July 16, 1996

Madam Chairman and members of the Subcommittee, I am pleased to submit testimony on the impact of tax law on land use, and to recommend changes to the tax code that would encourage private, voluntary conservation of land. I thank Chairman Johnson for calling this hearing, and also Congressmen Zimmer and Houghton for their leadership in advocating new legislation to encourage land conservation. I also commend the Subcommittee for making this effort to increase public and Congressional awareness of this important issue.

I am President of the Land Trust Alliance (LTA), a national membership organization serving the nation's more than 1,100 local and regional land conservation groups known as land trusts. Land trusts are nonprofit, tax-exempt land conservation organizations that are organized to protect natural areas, agricultural land, habitat, wetlands, greenways, urban gardens, recreational properties, and other kinds of conservation land for public benefit. Local and regional land trust organizations operate in every state, and have helped to protect nearly 5 million acres of irreplaceable open land. Together, these land trusts are supported by close to a million individual members.

Land trust organizations work to conserve selected lands of significant public value; many also act as community planning advisors, and nearly half conduct environmental education. No matter what their individual goals and methods, all land trusts share a philosophy of private, voluntary, common-sense, solution-oriented land conservation. Land trusts succeed through nongovernmental, nonregulatory, local citizen initiative. As a recent article in <u>Small Town</u> magazine stated, "Today's land trusts occupy a niche that links broad public interests in landscape protection with the desires and interests of individual landowners."

In communities across the country, land trusts promote good land use, which requires thoughtful planning for both development and open space. I am pleased to provide the committee with copies of a recent book on this topic, <u>Land Use in America</u> (Henry L. Diamond and Patrick F. Noonan, Island Press, 1996), to which I was asked to contribute an article. My testimony today is consistent with the tax recommendations in that article, beginning on page 257.

Land conservation tools. Land trusts rely on private action to save land. Their methods include acquisition of land and conservation easements by gift, purchase, or bargain (below market value) purchase; limited development that combines protected open space with appropriate development; acquisition of land for subsequent conveyance to public conservation agencies; land exchanges; and other direct methods. But these actions, though primarily private, are influenced significantly by public laws, policies, programs and rules. In particular, the land transactions that are at the heart of land trusts' work are affected substantially by incentives and disincentives in the tax code. While landowners virtually

never conserve land solely for tax benefit, their decisions are usually determined in part by a cost-benefit analysis of the tax consequences of various options for managing their assets.

Conservation Easements. One of the principal ways land trusts protect land is by working with landowners to design conservation easements. The landowner, by means of a recorded legal instrument, restricts -- usually in perpetuity -- rights to use the land in delineated ways that would harm its conservation values. The extinguished rights are tailored for each property, depending on its conservation values and the owner's wishes. The recipient of the easement, either a nonprofit land trust or government agency, agrees to monitor and enforce the terms of the easement. Thus, the land remains in private hands, in productive use, and on tax rolls, but henceforth may not be used in agreed-upon, environmentally harmful ways. If the easement is perpetual, all future owners are also bound by the agreement. The monetary value of an easement, determined through a "before and after" appraisal, is generally equal to the amount by which the restrictions reduce the value of the property.

For the value of a conservation easement donation to qualify for a charitable deduction under I.R.C. Section 170(h), the agreement must meet rigorous public benefit tests. A qualified conservation easement must be perpetual and donated to a nonprofit that can enforce it appropriately, or to a government agency. It must meet one or more of the conservation purposes under law: for public recreation or education; for the protection of habitat; for the preservation of open space that has scenic qualities benefitting the public, or for the protection of open space which is consistent with governmental conservation policies. Historically important land, or certified historic structures, also qualify under 170(h).

<u>Current tax code incentives.</u> Several incentives for land conservation already exist in the tax code. However, their applicability is often limited.

Income tax deductions. The value of a donation of land or a qualified conservation easement is generally deductible from taxable income. However, the deduction for gifts of appreciated property is limited to 30 per cent of the taxpayer's contribution base in the year of the gift, with any additional value deductible in the five succeeding tax years. Thus property owners whose land or extinguished development rights are worth a great deal, but whose income is modest, are unable to deduct much of the gift value. In addition, an easement donated to protect land on which the mineral and surface estates were first separated after 1977 is unlikely to qualify as a deductible charitable gift under current tax law.

Reduction of estate taxes. Gifts of land and easements for conservation can also lower estate taxes by reducing the value of the taxable estate. This alone can be a major incentive for conservation donations, because land in an estate is typically valued and taxed at its development potential. All too often heirs without other sizable assets with which to pay the estate tax bill must sell for development land that was previously undeveloped or in low-impact use. So while current law does encourage sophisticated taxpayers with good estate planning advice to donate land or easements for conservation, land in the estate of a decedent who did not, or could not, take such steps will often have to be sold. Current law does not permit the heirs to make conservation donations to reduce estate taxes. In addition, in areas of rapidly escalating land values, the long term estate tax benefit of a conservation easement donation may not be substantial enough to serve as a strong incentive for conservation.

Bargain sales. It is often in the best interests of both a landowner and a cash-strapped conservation agency or nonprofit to transfer land through a bargain sale. The seller can claim as a charitable gift the difference between the land's fair market value and the amount he receives for the land. However, for determining the taxable gain on the transaction, current law generally requires that the taxpayer's basis in the property be allocated between the sale and gift portion. The taxpayer is denied any tax benefit for the basis assigned to the gift portion, thus diminishing the tax benefit and the incentive for a substantial bargain sale.

Recommended changes. The Land Trust Alliance supports six changes to the tax code that would strengthen incentives for land conservation.

- 1. We endorse the estate tax incentive in H.R. 864, the American Farm Protection Act, sponsored by Congressman Houghton. This legislation would exempt from estate tax the value of certain land subject to a qualified conservation easement. The legislation targets the benefit to land adjacent to metropolitan areas and national parks, where development pressure and land values tend to be greatest, and where the need to protect open space is particularly keen.
- 2. We endorse H.R. 522, the Federal Open Space Acquisition and Preservation Act, sponsored by Congressman Zimmer. This bill would permit an executor to donate land or a conservation easement to a government agency and credit the value of the donation against estate taxes owed. This provision would go far to diminish forced sales of conservation land by heirs in order to pay estate taxes. We recommend that this proposed benefit be extended to gifts of land and conservation easements made to any "qualified organization," as described in Section 170(h)(3) of the I.R.C., which includes both public agencies and nonprofit conservation organizations.
- 3. We endorse H.R. 523, the Land Preservation Tax Fairness Act, also sponsored by Congressman Zimmer. This bill would change the way that the gain on bargain sales of land or conservation easements is calculated for tax purposes. It would allow the entire basis in the property to be deducted from the gain realized, instead of requiring allocation of basis between the sale and gift portions of the transaction.
- 4. We recommend that the limitations on deductibility of gifts of land or conservation easements be liberalized. Because these gifts tend to be large, one-time gifts, and serve a high priority public purpose, incentives for such gifts should be strengthened and should apply to people of modest incomes as well as to the wealthy. We recommend that the deduction for conservation gifts of appreciated land or easements be increased to 50% of the taxpayer's contribution base, and that the portion of the donation not deductible in the year of the gift be deductible in subsequent tax years without limitation, until it is used up.
- 5. We endorse Title 5 of S. 910, which lifts an unnecessary exclusion from qualified conservation easements of land on which the surface and mineral estates are separated. Current tax law unnecessarily restricts the deduction for conservation easement donations that protect land on which the mineral estate was first separated from the surface estate after June 13, 1976. If the estates were separated before that date, the owner can make a deductible easement gift, as long as he can demonstrate that the probability of surface mining on the land is "so remote as to be negligible" However, when the surface and mineral estates were first separated after June 13, 1976, an easement donation generally does not qualify as a deductible charitable donation, even if the remoteness test can be met. This provision is already discouraging the protection of some environmentally significant properties and its negative impact will only increase as time passes. It is our view that the burden of proof placed imposed by the "so remote as to be negligible" test is adequate and appropriate to all property on which the mineral and surface estates are separated. There has been no abuse in 20 years under this law, and no instance in which land meeting the remoteness test was subsequently subject to surface mining. Title 5 of S. 910 (the Senate version of H.R. 864) would correct this problem by permitting deductible conservation easements on properties with severed mineral estates without regard to the date of separation, as long as the remoteness test can be met.
- 6. We endorse incentives that would encourage good conservation management practices. The incentives described above would go far to encourage voluntary conservation through gifts of land and easements to conservation organizations and agencies. However, we know that acquisition of land and easements -- by purchase or gift, by land trusts or government -- cannot adequately protect entire watersheds, habitats and other key open lands. Land conservation will continue to depend upon the management practices of private property

owners. Thus we endorse the concept of rewarding, through additional income and estate tax incentives, those property owners whose management practices significantly advance public conservation policy goals -- for example, landowners who enter into binding agreements to manage for protection of endangered species habitat. To ensure that the public investment in such incentives is sound, their scale should be consistent with the public benefit received, the greatest incentives being offered for the longest term agreements.

Tax reform proposals. Finally, I would like to note the impact that the various proposals for a "flat tax" would have on land conservation. Like other members of the nonprofit sector, land trusts have serious concerns about any proposal that would end the charitable deduction. Unlike most other charities, however, land trusts rely on gifts not only for operating income, but also to carry out the basic function for which they are established and upon which their tax-exempt status is generally based. Without gifts of conservation land and easements, land trusts would have limited ability to carry out their missions. Flat tax proposals that allow deductions for a limited amount of annual giving do not address the matter of significant land and easement gifts, most of which are large, one-time donations whose value is far above the charitable deduction limits discussed in any of the flat tax proposals. We urge the committee, when evaluating such proposals in this and future Congresses, to give special consideration to their impact on the ability of private landowners to conserve their property through voluntary gifts of land and conservation easements.

The Land Trust Alliance is pleased to offer our assistance and expertise on the effect of the tax code on land conservation, and we encourage the Subcommittee to call on us. Thank you for devoting your time and attention to this important matter.

Chairman JOHNSON. Thank you very much. Mr. Bell.

STATEMENT OF A.I. (IRV) BELL, PRESIDENT, OHIO FARM BUREAU FEDERATION, INC., ON BEHALF OF AMERICAN FARM BUREAU FEDERATION

Mr. BELL. Thank you, Madam Chairman.

My name is Irv Bell. I, along with my wife, Jean, and son, Matt, operate a feed grain, hog, and beef cattle farm in Muskingum County, Ohio. Our farm has been in the family for six generations. I serve as the elected president of the Ohio Farm Bureau Federation, and I am pleased to represent the American Farm Bureau Federation at today's hearing.

The Farm Bureau's interest in tax policy and its impact on land use is keen. The production of food and fiber requires the use of large amounts of land. Roughly 43 percent of the total land in this country is farm- and ranchland. If you do not count land owned by State and Federal Governments, farm- and ranchlands account for

almost 70 percent of the privately-owned property.

First on the list of concerns that farmers and ranchers have about taxes that impact land use is the Federal estate gift tax. Like our farm, many farms and ranches are multigeneration family businesses. Estate taxes can make it very difficult for a family to continue to farm after the death of a loved one. When this happens, farmland that would normally remain in the family business is often sold for other uses.

To try to minimize the impact of estate taxes on a family business, some farmers seek professional estate planning advice. A good estate plan may require an accountant, an attorney, a financial planner, and an insurance agent. Establishing an estate plan costs money and takes time. It can be such a drain on the ongoing business and strain to family relationships that some farmers do not plan.

The Farm Bureau has long called for the elimination of estate and gift taxes. If this is not feasible, modifications are needed to reduce the burden on family farms and ranches. Farm Bureau supports increasing the current \$600,000 exemption to \$2 million and indexing the \$2 million for inflation. Because land is not easily gifted in small blocks, we recommend that the yearly gift allowance be increased to \$50,000.

We support unlimited use valuation under section 2032A and believe that cash leasing should not trigger recapture. Targeted tax relief for small businesses should be enacted, and estate taxes should be deferred until a family farm is sold by the heirs. Farm property that is restricted by a voluntary conservation easement should be exempt from estate taxes.

The capital gains tax is another tax that impacts land use. Many farmers and ranchers nearing retirement or in retirement are interested in selling land to younger farmers and ranchers, including family members. The current 28-percent capital gains tax discourages land transfers. Rather than selling farmland to the next generation, land is often held by the older generation until death and then becomes subject to estate taxes. My personal situation illustrates this point.

I grow crops and raise livestock on the farm next door to ours which is owned by my 90-year-old uncle. Both he and I would like to see that ground remain as farmland, but he is reluctant to sell it to me because of the capital gains tax. He purchased the ground during the thirties for around \$100 an acre, and today it would be worth several times that if it were sold for development. Unless capital gains taxes are reduced, it is very likely that my uncle will hold his farm until he dies. I do not know if my cousins will be willing to rent or sell the land to me for farmland when they can sell it to a developer for much more.

As with the estate and gift tax, Farm Bureau supports eliminating the capital gains tax. If that cannot be done, we recommend a maximum rate of 15 percent and indexing assets for inflation. Another good option would be to allow retiring farmers and ranchers to sell land and put the money into a pretaxed IRA-type account.

Farm Bureau recommends several additional tax law changes that we believe would help maintain adequate farmland for future generations. Tax incentives should be provided for expenses required to meet mandated environmental policies. There should be tax deductions for contributions of voluntary easements. Bond rules should be changed to localize the definition of a first-time farmer and to allow loans to those purchasing farmland from family members.

More information on these proposals is contained in my written statement.

Finally, it is important to point out that the amount of taxes that farmers and ranchers pay in operating their businesses has an indirect impact on land use. The larger the business tax burden, the more likely farmers are to stop farming and that farmland will be converted to other uses.

In conclusion, Farm Bureau recommends that the Tax Code should be changed to minimize the impact on land use decisions made by farmers and ranchers. Farm Bureau's priorities are repeal or modification, if repeal is impossible, of estate taxes and capital gains taxes.

Thank you.

[The prepared statement and attachment follow:]

STATEMENT OF
THE AMERICAN FARM BUREAU FEDERATION
PRESENTED BY
A. I. (IRV) BELL, PRESIDENT
OHIO FARM BUREAU FEDERATION, INC.
TO THE
HOUSE WAYS AND MEANS COMMITTEE

SUBCOMMITTEE ON OVERSIGHT
REGARDING
THE IMPACT OF TAX LAW ON LAND USE

July 16, 1996

Thank you for the opportunity to testify at this hearing on the impact of tax law on land use. My name is A. I. (Irv) Bell. I, along with my wife, Jean, and son, Matt, operate a feed grain, hog and beef farm in Muskingum County, Ohio. I serve as the president of the Ohio Farm Bureau Federation.

The American Farm Bureau Federation's interest in tax policy and its impact on land use is keen. Production of food and fiber by farmers and ranchers requires the use of large amounts of land. Roughly 43 percent of the land in this country is farm and ranch land. When the lands owned by federal and state governments are subtracted, farm and ranch land account for almost 70 percent of the privately-owned land.

Chairwoman Johnson, when you announced this hearing, you made a very important statement, "A number of provisions of current law have both intended and unintended consequences for land use." While public policy is usually made with the intent of doing good, often little thought is given to the "unintended consequences." Our comments will address both intended and unintended consequences of the current tax system.

Federal Estate Taxes

At the top of the list of concerns of farmers and ranchers about unintended consequences of the current tax system is the federal estate and gift tax. Farms and ranches are ongoing businesses. Many of these businesses are multi-generation family businesses. The death of one member of the business can directly impact the ability of remaining members of the business to carry on operations after paying estate taxes. Land that would normally remain in the family and be devoted to agricultural production is then available to be put to other uses. Thus, the current federal estate tax law has, at times, the unintended consequence of forcing family-owned farms out of business and possibly shifting agriculture land to other uses.

Owners of these multi-generational farms and ranches often seek legal advice for estate planning to structure their financial assets and farming and ranching operations to minimize the estate tax consequences of the death of a member of the business. These actions are costly and may reduce the economic efficiency of day-to-day operations. Land is not easily gifted in small blocks to avoid the gift tax on yearly transfers, therefore, limiting the usefulness of gifting as an estate planning tool.

Farm Bureau policy has long called for the elimination of estate and gift taxes. This would be the simplest, cleanest approach to create more economic efficiency. If elimination of the estate and gift tax is not politically feasible, there are ways to lessen the unintended consequence of forcing farmland to be sold and possibly shifting to a different use.

The current per person exemption for assets in an estate is \$600,000. This exemption amount was last changed in 1987. Farm Bureau policy calls for increasing that exemption to \$2,000,000 per person. Exact figures are not available, but it is a reasonable estimate that 95 percent, and perhaps as many as 98 percent, of the farmers and ranchers would be exempt from estate taxes if the per person exemption was increased to \$2,000,000 and then indexed for future changes in the overall price level. These farms could then be kept in the family and continued as ongoing husinesses.

Another way to lessen the potential for the estate tax to force a change in land use is through special-use assessment under section 2032A. This provision allows for land to be valued for estate tax purposes at its agricultural value rather than its market value. Current law limits the special use evaluation to a reduction in value of \$750,000. Removing the limit, or at least increasing the minimum, would reduce the potential for land to change uses to meet the cost of estate taxes, especially near large urban areas and around protected areas such as national parks. Cash leasing of farmland should be allowed under the special use evaluation.

Many other approaches could be used to help lessen the unintended impact of estate taxes. Targeted estate tax relief for small businesses should be enacted and estate taxes should be deferred until a family farm is sold by the heirs. The yearly gift allowance should be increased to \$50,000 per year so that land could be transferred before the death of the owner. Farm property that is restricted by a voluntary conservation easement, while actively farmed by the heirs, should be exempt from estate taxes. These would all lessen the sting of the current estate tax system, but they would make a complicated tax system even more complex.

The best economic reform would be to repeal the estate and gift tax. The second best would be to increase the personal exemption to the point that most farms and ranches would not be adversely impacted by the estate tax. The third best solution is to expand the number of ways that estate taxes can be reduced or delayed. If tax reform is to truly make the tax system simpler and reduce the unintended consequences, eliminating the estate and gift tax is the best option.

Capital Gains Taxes

The capital gains tax is another tax that has unintended consequences for land use and is closely tied to estate and gift taxes. The capital gains tax is a tax on asset transfers from one form to another, such as from farm land to certificates of deposits in a bank. The tax can be avoided by simply not making the asset transfer.

Many farmers and ranchers nearing retirement or in retirement are interested in selling land to younger farmers and ranchers, including family members involved in the farm or ranch operations. The current 28 percent capital gains transfer tax is a large impediment to taking such action. Rather than making an orderly transition of land ownership from one generation to the next, the land is often held by the older generation until death and then caught in the estate tax web discussed earlier.

Part of the problem with the capital gains tax is that it is a tax on the total dollar gain in value, including the portion of the gain that simply reflects the change in the overall price level for the economy as a whole. For example, farmland is often held for 30 years or more. Over the last 30 years, the overall price level as increased by roughly three times. Land valued at \$500 per acre in 1966 would have to sell for \$2,000 per acre in 1996 for it to have the same purchasing power as the \$500 had in 1966. Any increase beyond the \$2,000 would be the "real" gain in the value of the land. Capital gains taxes are paid on the entire increase in the value of the land, not just on the real gain. Once again, this law leads to economic inefficiencies and unintended consequences.

As with the estate and gift tax, the best policy reform approach would be to eliminate the capital gains tax. If that cannot be done, the gain should be indexed for the change in the overall price level and the real gain taxed at a lower rate of 15 percent. Another option would be to allow retiring farmers and ranchers to sell land and put the money into an IRA-type account and pay

taxes when the money is withdrawn from the account. This would be a positive economic incentive leading to a positive intended outcome.

All of these approaches would allow for an orderly transition from one owner to another and increase the potential for land to remain in production agriculture rather than be shifted to other uses.

Tax Policies With Positive Intended Consequences

Chairwoman Johnson, as you noted in your comments in announcing this hearing, you are also interested in exploring tax policies that would have a positive impact on maintaining current land uses. There are several policies that would have a positive impact on farm and ranch lands.

TAX INCENTIVES FOR ENVIRONMENTAL MANDATES

Tax incentives should be provided for expenses required to meet mandated environmental policies. For farms and ranches with slim operating margins, mandated environmental expenses can turn operating profits into operating losses. If these losses continue for a few years, selling the land may be the only option for survival. Other farmers and ranchers are reluctant to assume the risk of expenses to meet the environmental mandates on the land. Thus, selling for non-production agriculture uses may be the only viable option. Providing tax incentives should help meet environmental policy goals while keeping land in agriculture, a positive intended consequence.

INCENTIVES FOR VOLUNTARY CONSERVATION EASEMENTS

Tax deductions for contributions of voluntary easements is another way to meet environmental policy goals while keeping land in agricultural uses. The easement could be to a public agency or a private conservation group.

PRIVATE ACTIVITY "AGGIE" BONDS

Several state governments have provided programs for "aggie bonds" that are used to help beginning farmers and ranchers purchase existing operations. Because of current federal rules for tax status of the bonds, they cannot be used for sales from one family member to another. As noted earlier, multi-generational family farms are common and transferring assets from one generation to the next is a big problem under the current tax code. This change would allow more land to stay in the family and lessen the chance that the land would become available for purchase for non-agricultural uses.

RISK MANAGEMENT ISSUES

Farmers and ranchers must deal with volatile income swings that result from unpredictable weather and markets. Tax code provisions that allow the matching of expenses with income are of great help. Cash accounting is an important financial management tool. Income averaging and IRA-type accounts that allow farmers and ranchers to defer income would also be of benefit. Also helpful would be changes in the tax treatment of disaster losses and control over the timing of tax payments during and after periods of natural disasters. Repeal of the alternative minimum tax would simplify the tax system for farmers and ranchers and allow them to more effectively manage their tax burden.

Many other tax law changes would help to maintain farmers and ranchers on the land and reduce the potential for the land to shift to other uses. Two Farm Bureau priorities are allowing for the full deductibility of health insurance premiums paid by the self-employed and increasing the amount that small businesses can expense each year. Annual expensing of preproduction expenses should also be allowed.

Implications for Future Tax Policy

This subcommittee faces a major challenge in considering the impact of federal tax policy on

land use. Current tax law has a major impact on land use because the overall tax load is large enough to cause land owners to seek legal means to reduce that tax load. Farmers and ranchers whose families have worked hard to accumulate assets in land do not want to pay confiscatory tax rates. Thus, they seek alternatives that may directly impact land use.

Two choices are available to deal with these problems. One option is to continue to add features to the current tax system to try to offset the negatives in the system. We have proposed some ways to do that for issues of particular concerns to farmers and ranchers.

The other option is to give up the idea of applying another batch of bandages to a troubled system and to start working toward reform of the entire federal tax system. We have made some suggestions for that approach as well.

We applaud the subcommittee for recognizing that inactivity is not a realistic option and encourage changes that will lead to either more positive intended consequences or less unintended consequences.

Thank you.

Agricultural Tax Legislation Supported by Farm Bureau In the 104th Congress

H.R. 12	American Farm Protection Act of 1995; allows farm property that is voluntarily restricted by a conservation easement to be exempt from federal estate taxes while actively farmed by heirs
H.R. 41	provides farmers and agribusiness with a 15 percent tax credit for capital expenses incurred in complying with federal, state and local environmental laws
H.R. 89	Family Farm Tax Relief and Savings Act; allows farmers, in contemplation of retirement, to invest proceeds from asset sales in an individual retirement account with taxes due only when funds are withdrawn
H.R. 501	provides that certain cash rentals of farmland will not cause recapture of the special estate tax valuation under section 2032A
H.R. 520	increases the maximum benefit under the special estate tax valuation rules to \$1.5 million
H.R. 844	Farmer Retirement Security Act; allows farmers, in contemplation of retirement, to invest proceeds from asset sales in an individual retirement account with taxes due only when funds are withdrawn
H.R. 864	American Farm Protection Act of 1995; allows farm property that is voluntarily restricted by a conservation easement to be exempt from federal estate taxes while actively farmed by heirs
H.R. 1298	provides that certain cash rentals of farmland will not cause recapture of the special estate tax valuation under section 2032A
H.R. 1408	allows farmers and ranchers the option to count income from crop insurance proceeds and disaster payments in either the year of the disaster or the following year
H.R. 1588	expands the applicability of special tax rules governing the tax treatment of livestock sold to include all types of natural disasters, not just drought
H.R. 2078	lowers excise tax on draft cider from the higher wine rate to the lower beer rate
H.R. 2190	Family Business Protection Act of 1995, targets estate tax relief to family businesses by forgiving estate taxes on family business assets provided the family business continues to operate
H.R. 2218	Farmland Preservation Act of 1995; allows farm property that is voluntarily restricted by a conservation easement to be exempt from federal estate taxes while actively farmed by heirs
H.R. 2676	increases the opportunities for farmer owned cooperatives to own facilities that process and refine products produced by members by allowing corporations that sell such facilities to a qualifying farmer cooperative to defer the gain as long as the proceeds from the sale are reinvested
H.R. 3124	increases the annual expensing allowance for small businesses rom \$17,500 to \$50,000
H.R. 3251	Aggie Bond Improvement Act; changes the federal laws to allow beginning farmers to purchase land from family members and customizes the definition of a first-time farmer by establishing standards on a county specific basis

- H.R. 3550 would allow the self-employed, in contemplation of retirement, to invest proceeds from asset sales in an individual retirement account with taxes due only when the fund are withdrawn
- H.R. 3559 would allow farmers to place an amount equal to their 1996 FAIR Act market transition payment, or \$40,000 whichever is less, into an income tax deferred account called a "Farmer IRA"
- H.R. 3729 allows farmers to deduct a percentage of expenses incurred to cultivate, maintain and develop replantings made because of natural disasters, i.e. irrigation equipment, trellises

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Chairman JOHNSON. Thank you very much, Mr. Bell.

This is to the whole panel. Is the loss of open space a national

problem, or is it a regional problem?

Ms. HOCKER. Madam Chair, I would be glad to take a first crack at that. I think it is clear that it is a national problem. It isn't limited to regions alone.

We are seeing, for example, the growth of land trusts in response to the loss of open space happening all across the country. They used to be limited to the Northeast and the east coast. Now we are seeing land trusts growing rapidly in the Southeast, in the upper Midwest, Northwest, in the west coast, Southwest, everywhere, and I think that that is because—I know that is because—the loss of open space is a national problem.

Chairman JOHNSON. I am thinking about the restrictions in the Houghton-Payne bill and other such ways of targeting the benefits, and I am wondering if the land trust mechanism is capable of handling the problem in some areas, but not in others; whether a targeted bill would clearly be a step forward, but would it be an ade-

quate response?

Ms. Hocker. Well, the answer is that the kinds of incentives that we are talking about ought to apply, in an ideal world, to every piece of land that is valuable to the public for conservation and is in danger of being lost to that purpose. In the real world, unfortunately, you do what you think can best be done and apply limitations accordingly.

Chairman JOHNSON. Mr. Lindstrom.

Mr. LINDSTROM. Madam Chairman, I would agree with what Ms. Hocker said. I would add, though, I think in our conversations with a number of people, there is somewhat of a misconception about the extent to which the American Farm Protection Act actually does apply.

If you take a look at a map that has been produced by the Department of Commerce, it shows metropolitan statistical areas, and then you take—and basically a metropolitan statistical area is an area that has an urbanized area of roughly 50,000 or more people, and it includes the entire county boundary surrounding that area.

So you can imagine, if you took that outer boundary and added 50 miles to it, that you pick up a considerable amount of land, and I know in Congressman Laughlin's district, while it looks as though he is pretty far removed from metropolitan areas, because of the way that "metropolitan area" is defined by the Department of Commerce, and then adding the 50-mile radius really picks up a considerable amount of land. And certainly studies done by the American Farmland Trust had indicated that some of the best farmland in the country, and that which is under the most significant pressure, is within those radiuses that have been proposed in the bill.

So while it would be ideal to cover the entire country, we think that the metropolitan statistical area is a reasonable basis to start

from.

Ms. HOCKER. Madam Chairman, if I may add, these limitations apply in the American Farm Protection Act, but many of the other incentives that we have proposed would not be so limited, and this is among the reasons that we are proposing them. We think that land conservationists need a whole range of tools to protect land.

Chairman JOHNSON. Thank you.

Mr. Zimmer.

Mr. ZIMMER. Thank you, Madam Chair.

I would like to ask the panel, starting with Ms. Hocker, whether, based on your practical experience in land preservation, you think that the two pieces of legislation that I have introduced, one to allow the payment of land in lieu of cash for estate tax liabilities and the other to eliminate the bargain sale treatment of belowmarket sales of conservation easements, would have a practical impact on the behavior of individuals and would actually result in a substantial preservation of open space.

Ms. Hocker. The answer to both questions—the answer for both pieces of legislation is yes. The ability of heirs to make decisions about the land that the decedent was unable or didn't know enough to make is absolutely critical, and I know of situations where heirs would have probably made the decision to protect the land or to donate an easement to protect the land if that option had been available.

I would add that not only would your proposal for a tax credit for land that is donated or easements that are donated after death be critical for lands that are the highest value, but even if it were a tax deduction—the ability of an heir to make a donation of land or an easement for conservation and get a tax deduction, rather than a credit from the taxable estate—it would be a benefit; heirs would make that change.

Your piece of legislation on bargain sales will be increasingly important, I believe, because as those landowners who are in a position to make a donation of land or an easement have done so or decided not to and have made their decision, there are more and more landowners who cannot necessarily afford to make an entire gift wanting to protect their land. For them, the bargain sale is a very good compromise. They make a partial gift, they get a partial donation, they also get some income; and I think that tool will be increasingly important to land protection. So that bill is also extremely important.

Thank you for introducing both.

Mr. ZIMMER. Thank you.

Mr. Lindstrom.

Mr. LINDSTROM. Congressman Zimmer, I agree with Ms. Hocker, and I would add that the region that the Piedmont Environmental Council serves is bordered almost along its entire nine-county length on the west by the Shenandoah National Park, which is one of the most heavily used parks in the United States, closer to more people than probably most any other national park, and I think that one of the concerns of the Park Service is how to protect that park. I think that the legislation that you have introduced, it certainly will be a significant additional tool for them.

Ironically, I will have to tell you that there is legislation afoot in the Congress that would freeze the boundaries of the park so that it could not even be expanded by the gift of land, and obviously that would be counterproductive to the effort that you have

been very appropriately pursuing.

Mr. ZIMMER. Thank you.

Chairman JOHNSON. Mr. Laughlin.

Mr. LAUGHLIN. Thank you, Madam Chairwoman.

Mr. Lindstrom, I appreciate your explanation. It does demonstrate the broad expanse of the bill, and I understood that, other than just San Antonio or Houston or the very large cities. But again, we have some land that has artificial values along our interstates that would not, and I can think of one county along Interstate 10 that none of these definitions would reach, and it concerns me. That is why I mention it.

The staff gave me a question for you, Mr. Lindstrom, but apparently an answer was given earlier about the types of property that are eligible for exclusion under the American Farm Protection Act, that apparently the answer should have been broader. Is it broader than just farm- and ranchland, or is it confined to just farm- and ranchland?

Mr. LINDSTROM. No, Congressman. It is broader than that. The American Farm Protection Act qualifies the land under an existing section of the Tax Code, which is section 170(h), which lists a number of categories that, if you have land which falls under one of those categories, it will qualify not only for a tax deduction under existing law but also for the exclusion provided by this proposal.

It would include certainly prime farmland and ranchland and forestland, but also it would include environmentally sensitive land, land that was a particularly important habitat for endangered species or for other flora and fauna. And so it is much broader than simply actively farmed land or forested land.

Ms. Hocker may want to add to that.

Ms. HOCKER. I think you have covered it.

Mr. LAUGHLIN. Ms. Hocker, I appreciate your comments about the separation of property. It reminds me, when I met with some members of the Russian duma, they did not understand the ownership being different from the surface and below the surface.

Madam Chairwoman, we do in Texas, and all I can say is, I wish I owned a lot more of the under-the-surface than the surface, since

I don't own much of either.

Ms. Hocker, tell us what the problem is, and how extensive you

view it to be, and what you recommend to change that.

Let me just say to you that while I come from an area that primarily is oil and gas production and some sulfur—and that has just about gone away—coal mining has become more prevalent in recent years in my part of Texas, and, frankly, the strip mining that we think about being so horrible, there are requirements now by some landowners that that land be rehabilitated. And I have a friend who has one of those ranches that they have taken the coal out. Frankly, the surface looks better and he thinks it is better than it was before the coal miners.

Can you elaborate some on what the problems are from your

viewpoint and some solutions?

Ms. HOCKER. Yes. Thank you, Congressman, for the opportunity to do that, because a very obscure point of the law is holding up a number of donated conservation easements currently. The law governing the deductibility of conservation easements allows for the donation of an easement over land where the surface and subsurface rights have been separated, where the owner of the surface doesn't own all of the mineral rights.

If the rights were first separated before 1976, and if the owner can show that the likelihood of surface extraction is so remote as to be negligible, an easement that is donated on property where the mineral rights were first severed from the surface rights after that date in 1976, it is extremely difficult to give a qualified easement over such property.

We don't see any reason for having an artificial date in there. It is important to be able to show, of course, that the surface is unlikely to be disturbed, because taxpayers don't want to grant tax incentives to landowners on land where the surface will be dis-

turbed by major mining, perhaps.

But there is no reason to have an arbitrary date, and for land where the rights were first separated before that date a deductible conservation easement property is eligible, and for land where surface rights were separated from mineral rights after that, such easements are not eligible. It doesn't make any sense.

The solution simply is to eliminate, eliminate the date, and treat all land equally. If the rights are severed but the landowner can show that the likelihood of surface extraction is so remote as to be negligible, let those landowners donate conservation easements. It is simply a matter of removing the date from the current law.

Mr. LAUGHLIN. Madam Chairwoman, I see the red light is on,

but I would like to ask Mr. Bell a question.

Chairman JOHNSON. Go right ahead.

Mr. LAUGHLIN. Mr. Bell, you may not be the first bona fide farmer that has been before this Committee, but my memory is, you are the first since I have been on it. So I want to ask you, if you could, from a farmer's viewpoint, tell us why the estate gift tax is such a problem for the agriculture community in preserving the valuable land for agriculture purposes from one generation to the next, particularly when we read from time to time that it is extremely difficult for a new generation of farmer to get into the agriculture business.

And also as part of your answer, if you could tell us whether there is anything, other than raising the estate and gift tax limitation or abolishing it, that would be better. In my opinion, these are the only major tax problems with preserving the property for agriculture purposes.

If you could offer the viewpoint of a farmer I would appreciate

Mr. BELL. If you don't mind, I would like to take the liberty to also talk about capital gains taxes and their ramifications.

Mr. LAUGHLIN. That was part of my question, because I said in addition to the estate gift tax.

Mr. BELL. Thank you.

As I sat and listened to my colleagues on the panel discussing the farmland trust issue, certainly we who are farmers appreciate that effort. My home State of Ohio is an agricultural State. But more than that, we are an industrial State, a highly populated State. Therefore, we have great interest in our State in terms of preserving farmland.

I relate back to your discussion and your questions about the 50-mile radius. I am one of those farmers who barely falls outside of

that 50-mile radius.

Mr. LAUGHLIN. You need to move your farm then.

Mr. BELL. I need to move my farm. I have thought of that often. We are about 70 miles outside of Columbus. I would like to come back to what I mentioned about my uncle's farm before.

We farm several farms in our community. My son and I and a hired employee, we are farming a lot of land that a lot of farmers used to farm. Several of those farms, two of them, have been sold within the last year for development. This is a loss of open space. This is conversion of farmland to purposes that will never be open space again. We will never see farmland on those acreages again.

Again, citing my uncle's example, his farm has a basis of roughly \$100 an acre. The capital gains would be huge if he were to sell

it to me today.

Now, if he lets it go through probate and the basis is stepped up, his heirs, my cousins, will be the ones dealing with that. It will be their decision whether they want to see it remain as farmland and whether they and I can cooperatively come to an agreement that

lets that happen.

In his specific example, the Federal estate tax, depending on how the land is valued at the time of his death may or may not be a huge problem. We know that capital gains, if he sold it to me today, would be a problem. But knowing what the market value of that land is, not for what I would call its best use, but for what real estate developers would call its best use, I could not possibly afford to pay to purchase that farm.

Mr. Laughlin. It sounds from your answer, Mr. Bell, that your cousins or none of the children of your uncle who has the farm next door are interested in maintaining the family tradition of farming that particular property; is that correct?

Mr. Bell. No. If I were to poll them today—there are four of them—I think that they would say, "Yes, we want to see it kept as a farm."

Mr. LAUGHLIN. My question specifically: Would they, the individuals, farm it?

Mr. Bell. No, they as individuals are not interested in farming it.

Mr. Laughlin. And I wanted that answer, because you almost went to the next one that I want to ask, and that is, is there a significant reason, from an agricultural viewpoint, to have property passed to someone other than a relative, either through, let's just say, sale, when the agriculture use is going to be maintained—using your cousins as an example of people who are not going to farm the property but would like to see it continued in a farm operation—to have some tax benefit to preserve that agriculture use, rather than in the instance—and I don't know your cousins, but I am going to talk about them.

Mr. BELL. That is fine.

Mr. LAUGHLIN. Perhaps sell it for real estate development as a

supermarket or a mall or some other nonagricultural use.

Mr. BELL. Right. We don't know how this is going to play out. We have talked about it. To me, the logical thing would be for my uncle and me to agree on a fair market price for agriculture prior to his death. If he and I could come to that agreement, I would pur-

chase it from him prior to his death. But the capital gains restric-

tion probably will not let that happen.

Mr. LAUGHLIN. Mr. Lindstrom, the Houghton and Payne bill, I understood that use of the property was one of the considerations. Would Mr. Bell's family example fall within that bill where there wouldn't be the significant tax consequences if the property's use continued to be agriculture?

Mr. LINDSTROM. It would be protected under the American Farm

Protection Act.

I would need to look at a map to see physically whether you are within that 50 miles of that outer boundary of the Columbus metropolitan area. But the way the American Farm Protection Act works, if Mr. Bell's uncle were to put a permanent easement on that land that restricted it to farm use essentially, that land under the Houghton bill would pass estate tax free.

Mr. LAUGHLIN. Even to a total stranger? Mr. LINDSTROM. Even to a total stranger.

Mr. LAUGHLIN. The agriculture use would apply.

Mr. LINDSTROM. That is right. And that commitment to agricultural use, of course, would then continue under the terms of the easement regardless of who owned the land.

Mr. LAUGHLIN. I recommend, Mr. Bell, your organization, and other agricultural organizations, make as many Members of Congress aware of that benefit of the Houghton-Payne bill.

Thank you, Madam Chairman.

Chairman Johnson. I appreciate your questions. I did want to

pursue one other issue with Mr. Bell.

Your testimony raised some problems of equal importance. These aggie bonds that you referred to and the restriction that they can't be used for the purchase by one family member of the farmland from another family member—

Mr. BELL. Madam Chairman, I confess I am not as familiar with that as I could be. Could we get that information to you on that?

Chairman JOHNSON. Those are the kinds we ought to look at. It is those kinds of little glitches in the law that really affect circumstances like yours. Many farmers are in those circumstances, where the land was divided by a preceding generation, and yet those who work the land end up doing the work and getting the benefit later on, and finally it has to be sold outside the family for tax reasons.

The other thing that interested me was the need for farmers to be able to manage their income differently in terms of IRA contributions. I think that is something we need to look at, and we may want to look at. It goes more to the income security issue than the conservation issue, but we may want to look at some parallel right for older farmers, particularly, who sell a principal residence or sell their farm, to have some exemption from capital gains.

I don't know what proportion of the farm community has been consistent about their Social Security. Do small farmers generally

contribute to Social Security the whole 15 percent?

Mr. Bell. Yes, I would say so, yes, ma'am. I would totally concur and would really appreciate your saying that the interest of looking at an IRA-type investment for farmers is something that I as an individual and certainly we as an organization certainly support

and would be very much interested in working with you in any way we could.

Chairman JOHNSON. Particularly farmers paying the 15 percent, probably not many of them are investing in IRAs. It may be possible to turn over some of those proceeds to an IRA. We are looking at some formula that provides fairness. Or maybe a combination of those things with the conservation concerns. I thank you very much for your testimony.

Ms. Hocker, over the course of evaluating initiatives, we hope to have the help of your organization since you are right here near us. We will certainly keep in touch with all of you as we move forward.

The next panel is Tamar Osterman, the director of government affairs for the National Trust for Historic Preservation; Richard Kelly from South Windsor, Connecticut, representing the National Association of Home Builders; and Bruce MacEwen, the vice president of taxation, Portman Holdings, L.P., Atlanta, Georgia, on behalf of the National Realty Committee.

We welcome you all. We will start with Ms. Osterman.

STATEMENT OF TAMAR OSTERMAN, DIRECTOR, GOVERNMENT AFFAIRS, NATIONAL TRUST FOR HISTORIC PRESERVATION

Ms. OSTERMAN. Thank you, Madam Chairman. My name is Tamar Osterman. I am director of government affairs for the National Trust for Historic Preservation.

The National Trust is pleased to be here before the Subcommittee today. We commend the Chairman for holding a hearing on the subject of the impact of the Federal Tax Code on land use decisions. The National Trust has set as one of our principal goals to reverse the impact of decline and disinvestment in historic resources and historic communities. The Internal Revenue Code provides tools to address these problems with which I have dealt at length in my written testimony, and also an excellent opportunity in the form of legislation pending before Congress.

Between 1981 and 1987, the historic resources of older communities, particularly in urban areas, experienced no less than a renaissance. During that time, the historic rehabilitation tax credit stimulated nearly \$12 billion of reinvestment in cities and towns across the country. As a result of this powerful incentive, citizens rescued landmark railroad stations, hotels, schools, and office buildings from demolition. Historic preservation fueled the back-to-the-city movement of the seventies and eighties, bringing new life to warehouse districts, waterfronts, and downtowns that were the tattered remnants of our Nation's history and settlement.

In Connecticut alone, the rehabilitation tax credit generated an estimated \$213 million in investment, creating 8,000 jobs and the rehabilitation of 2,300 housing units. This economic activity, which often spurred reinvestment in surrounding areas, has been greatly diminished since the tightening of the passive loss restrictions in the 1986 tax act.

Today, private investment and preservation projects under the credit amounts to less than 20 percent of pre-tax act activity. Nonetheless, the investment tax credit continues to be an important tool for historic preservation and community revitalization, particularly

when it is combined with other government and private resources, such as the low-income housing tax credit. In fact, rental housing has been the single most important use for buildings rehabbed under the investment tax credit. But older neighborhoods, neighborhoods of residential homeowners, still need the tools to address the blight and abandonment that threaten entire communities.

For 30 years, from milltowns in New England and the South, to the industrial cities in the Midwest, historic communities have been in a spiral of decline and decay. Left behind in the surge to the suburbs and exurbs is an inventory of sound housing stock and older commercial buildings, much of which has historical or architectural significance.

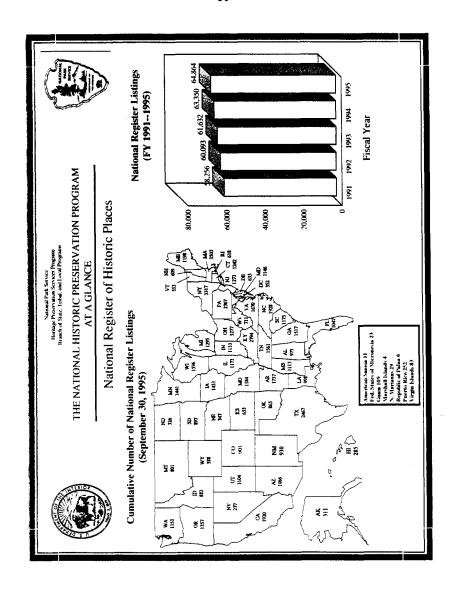
And while this disinvestment continues to occur, while we continue to abandon quality buildings and already paid for infrastructure, the surrounding countryside is fast disappearing under new

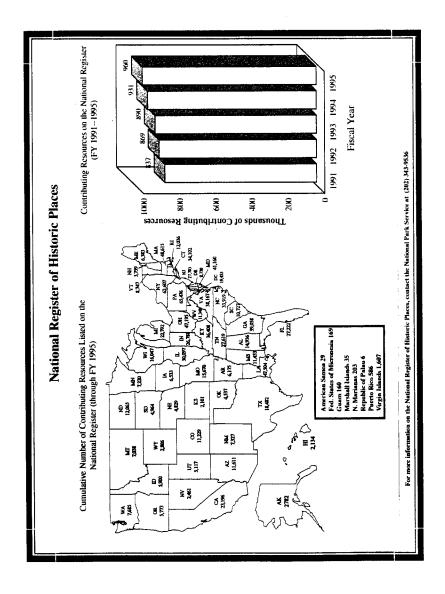
tract housing development.

The back-to-the-city movement of the seventies and eighties was really a back-to-the-historic-neighborhood movement. Today, more than ever, historic cities, towns, and communities need an incentive for home ownership. As we saw with the commercial rehab tax credit, when the incentives are in place, the response can be tremendous.

To my right are a couple of charts which we brought just to indicate the breadth of the historic resources in the country. The one is the cumulative number of National Register listings, which is 64,000, and then a chart that shows contributing resources in historic districts, 8,700 historic districts throughout the country and in each State.

[The following was subsequently received:]





H.R. 1662, the Historic Homeownership Assistance Act, sponsored by Representatives Shaw and Kennelly, is an effective answer to the need for an incentive for historic home ownership. This legislation calls for a minimum of government involvement and a maximum of private initiative.

H.R. 1662, which I thank the Chairman for cosponsoring, would provide a 20-percent credit for qualified rehab expenditures to homeowners who purchase and rehabilitate a historic home for use as a principal residence. The maximum credit allowable would be \$50,000 for each residence. But since this proposal is intended not only to foster home ownership and encourage rehabilitation of deteriorated buildings, but also to promote economic diversity and increase local tax revenues, individual taxpayers would be eligible for the credit without regard to income.

The credit would be available to homeowners in condominiums and cooperatives as well as single-family homes. It could be used by the do-it-yourself rehabber or someone who purchases a home rehabilitated by a nonprofit or for-profit developer. In that case the credit would accrue not to the developer, but would be passed through to the purchaser of the home. In this way the historic homeowner tax credit could be used to help offset the cost of purchasing a home.

As with the current credit, rehabilitation must be substantial: The greater of \$5,000 or the adjusted basis of an eligible building. However, if the property is in a census tract targeted as distressed for mortgage revenue bond purposes, or in an empowerment or enterprise zone, just a \$5,000 expenditure is necessary.

This provision is meant to make the credit usable in situations where the building has a much higher value relative to the value of the underlying land which is often true in deteriorated inner-city neighborhoods. It is a common misperception that historic neighborhoods contain only wealthy people and grand residences. The truth is that the majority of historic neighborhoods, because they are in the older areas of towns and cities, are home to people of modest means. In fact, almost one-third of all historic districts contain or are located in census tracts with poverty rates of 20 percent or greater.

Because many homeowners might not have sufficient tax liability to utilize this credit, this legislation creates a mortgage credit certificate program. Instead of a tax credit that he could not use, a home buyer could receive a certificate in the face amount of the credit. The home buyer would transfer the certificate to his mortgage lender in exchange for a reduced interest rate on his mortgage. The bank could then use the certificate to reduce its own Federal income tax liability.

The revenue implications of H.R. 1662 would be modest. The Joint Committee on Taxation has estimated the revenue loss to the Treasury at \$239 million over 5 years. This is largely due to the limited universe of eligible structures, which includes buildings listed on the national or State and local registers and contributing buildings located in national, State, or locally designated historic districts. The Park Service estimates that there are over 800,000 buildings that would qualify for the credit.

In closing, Madam Chairman, I want to note that the economic benefits of historic rehabilitation, while considerable and well documented, are not the only reason why communities pursue historic preservation as part of an overall revitalization strategy. The social, cultural, and historical benefits of rehabilitation have been verified repeatedly by addressing blight and abandonment and by restoring the tangible markers of a community's history, hope and pride can be restored as well as buildings. The results, to which many neighborhood residents can testify, include safer streets, more livable neighborhoods, and a social cohesiveness which are all too often absent in today's society.

Thank you, Madam Chairman. [The prepared statement follows:]



The National Trust for Historic Preservation

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Testimony of
Tamar Osterman, Director of Government Affairs
National Trust for Historic Preservation
before the
Subcommittee on Oversight
House Committee on Ways and Means
July 16, 1996

Madame Chairman, Members of the subcommittee, thank you for the opportunity to appear today to testify on the impact of federal tax law on land use. The National Trust for Historic Preservation is a non-profit organization with more than 265,000 members, chartered by Congress to promote public participation and education in historic preservation and to engage the private sector in preserving our nation's heritage. As the leader of the national historic preservation movement, the National Trust is committed to saving America's diverse historic resources and to preserving and revitalizing communities nationwide.

The Internal Revenue Code contains numerous provisions that directly and indirectly affect land use. Therefore, I will focus my testimony on those provisions which are particularly relevant to historic resources and historic communities.

I also want to present the National Trust for Historic Preservation's views on a very important historic preservation tax proposal, of which the Chair and 14 other members of the Ways and Means Committee are co-sponsors: H.R. 1662, legislation to provide a tax credit for qualified rehabilitation expenditures of a historic property as an owner-occupied home.

Background

Over the decades since World War II, a combination of social and economic forces, abetted in no small measure by government policies and programs, has produced a steady migration of population and business activity from large and small urban areas. Left behind in the surge to the suburbs and exurbs is an enormous (but dwindling) inventory of sound housing stock and older commercial buildings, much of which has historic or architectural importance, or both. Investment decisions have been greatly influenced by substantial subsidies provided for low-density, land consumptive development, particularly in the form of highway construction, and the demolition of existing building stock through the well-intentioned, but ultimately catastrophic buildozing of established urban centers and neighborhoods under federal urban renewal and highway construction programs. The result has been a spiraling cycle of blight, crime, and decline in urban tax base and services.

Tax incentives cannot reverse demographic trends, restore fiscal solvency to cities and towns, fight crime, or improve education. What they can do is provide, at the margin, a salutary corrective to the institutionalized bias toward out-migration of population and business activity and the consumption of open space at the expense of reinvestment in declining areas that are already equipped with buildings and infrastructure. In addition, where incentives are linked to the appropriate rehabilitation and reuse of buildings of historic or architectural value, the benefits of historic preservation—both tangible and intangible—can also be realized.

The economic benefits of reclaiming these buildings and the existing infrastructure which supports them are impressive. According Donovan D. Rypkema, author of <u>The Economics of Historic Preservation</u>, for every one million dollars spent on rehabilitation instead of on new

construction, \$120,000 will initially stay in the community; five to nine more construction jobs will be created; and total household income in the community will increase by \$107,000. Building rehabilitation outperforms new construction in the number of new jobs created, the increase in local income, and the impact on all other industries.

But while the economic benefits of historic rehabilitation are considerable, they are by no means the only reason why communities pursue historic preservation as part of an overall revitalization strategy. The social, cultural, and historical benefits of preserving both architectural gems and the ordinary places where ordinary people lived and worked have been verified repeatedly. By addressing blight and abandonment, and by restoring the tangible markers of a community's history, a community can restore hope and pride as well as buildings. The results, to which many neighborhood residents can testify, include safer streets, more livable neighborhoods, and a social cohesiveness that is all too often absent in today's society.

Provisions in the Internal Revenue Code which support the goals of historic preservation

Before turning to the provision which has had the greatest benefit for our country's historic resources, the historic rehabilitation investment tax credit, I would like to cite three other provisions in the code by which historic preservation benefits: the deductibility of interest on mortgage revenue bonds; and property owner income and estate tax exemptions for historic preservation easements held by qualified organizations.

Historic preservation easements provide key incentives for property owners to protect the facade and surroundings of historic structures or historic land areas from inappropriate development while retaining the property in private ownership. For example, the National Trust is in the process of acquiring an historic easement on the Clark-Ward House, an 18th century home listed on the National and Connecticut Registers of Historic Places, which is the oldest house in West Haven, Connecticut. The neighborhood surrounding the house is undergoing a transition from residential to commercial use, and the house itself was threatened by encroaching development. The historic easement will protect the Clark-Ward House in perpetuity, which has spurred a local non-profit organization to acquire the house in order to create a museum and an educational center for school children to learn about the history of the area.

As I noted earlier, the decline and disinvestment of our nation's older communities puts their historic resources, and the neighborhoods themselves, at grave risk. By allowing the interest paid on mortgage revenue bonds to be tax-deductible, the federal government is providing a significant incentive for reinvestment in older neighborhoods, thereby assisting states and localities in their efforts to target growth and development. Last week, Maryland Governor Parris Glendening announced a six year, \$72 million state-wide neighborhood conservation effort, aimed at revitalizing Maryland's older communities and encouraging investment in already built up areas. This initiative will be complemented by more flexible eligibility standards for \$40 million in MRB-financed mortgages for Baltimore County and other older Maryland suburbs, in order to attract homebuyers to those areas. In announcing this effort, Governor Glendening said he intends to continue using such incentives to help localities manage growth.

Historic Rehabilitation Investment Tax Credit:

Since 1976 the Internal Revenue Code has contained incentives to stimulate capital investment in income-producing historic buildings and the revitalization of historic communities. These include a 10 percent credit for the substantial rehabilitation for nonresidential purposes of buildings built before 1936 and, more significantly, the Historic Rehabilitation Investment Tax Credit, which applies a 20 percent income tax credit to qualified rehabilitation expenses on certified historic structures. Certified historic structures include properties listed in the National Register of Historic Places, or contributing properties within historic districts in the National Register of Historic Places, or located in federally-certified state and local districts. The effects of National Register listing are positive, by fact and by law. Listing does not give the federal

government control over private property nor does it preclude demolition of historic properties by the federal government or private or other governmental owners. Register listing confers benefits and opportunities, such as eligibility for the historic rehabilitation investment tax credit.

From 1981, when the historic rehabilitation investment tax credit was adopted, until 1987, when changes made under the Tax Reform Act of 1986 took effect, the historic resources of older communities, particularly in urban areas, experienced a renaissance. Nationwide, the historic rehabilitation tax credit stimulated nearly \$12 billion during that seven year period in the rehabilitation of historic buildings. As a result of this remarkable incentive, citizens across the country rescued landmark railroad stations (including Washington's Union Station), hotels (such as the Willard Hotel), schools and office buildings from decay and demolition. These restorations frequently catalyzed reinvestment in the surrounding neighborhood, thus adding value beyond that of the rehabilitation itself. Historic preservation fueled the "back to the city" movement of the 1970s and 1980s, bringing new life to abandoned and deteriorated warehouse districts, waterfronts, downtowns, and other remnants of an area's history and settlement which had previously been in tatters.

Connecticut has been one of the greatest beneficiaries of the historic rehabilitation tax credits. For the four years from Fiscal Year 1982 through Fiscal Year 1985, Connecticut ranked 11th in the number of approved rehab projects, and 12th in the amount of investment. In that time, 371 projects generated an estimated \$2.13 million in investment, creating over \$,000 jobs and the rehabilitation of 2,300 housing units. Hartford was among the top 50 cities in the nation in the number of tax incentive projects. However, the impact of the historic rehabilitation tax credit was greatly reduced by the passive-loss and income restrictions imposed on it by the Tax Reform Act of 1986. Today, private investment in preservation projects under the credit amounts to less than one-fifth of what it had been in its heyday. Connecticut experienced a drop of 76 percent in use of the credit, with investment declining from \$65.6 million in FY88 to \$11.9 million in FY88.

Nonetheless, the historic rehabilitation investment tax credit continues to be an important tool for historic preservation, particularly when it is combined with other government and private resources. According to the National Park Service, in FY 1994 the program leveraged \$483 million in private development activity nationwide at a cost to the federal treasury of approximately \$97 million.

Many of these rehabilitations involve the conversion of historic structures, particularly schools and office buildings, into residential rental buildings, creating affordable housing in downtown areas. In fact, housing has been the single most important use for rehabilitated historic buildings under the preservation tax credit program. Since the program began, over 131,000 housing units have been rehabilitated and over 66,000 have been newly created. And with the reduced incentive to utilize the credit post-tax reform, many developers have generated necessary leverage by combining the Historic Rehabilitation Tax Credit with the Low Income Housing Tax Credit, which was created in the Tax Reform Act of 1986.

For example, the Dunbar Hotel was built as a first class hotel for African-Americans who had no comparable place to stay in Los Angeles in the 1920s. For the next thirty years, the Dunbar flourished, but by the 1970s decline and disinvestment in downtown Los Angeles had taken its toll and the historic hotel housed only a few transients. Using the Low Income and Housing Rehabilitation Tax Credits, the Dunbar Hotel was restored in 1989 as the anchor for revitalization of the larger neighborhood. Today, it consists of 73 low-income apartments, four commercial spaces, a museum, and a senior center.

The Need for a Historic Homeowner Tax Credit

Despite being significantly undercut by the Tax Reform Act of 1986, the existing historic rehabilitation tax credit is presently the most valuable tool available for incentivizing historic preservation. What we still lack are the tools to address the problems of blight and abandonment that threaten entire older neighborhoods and communities. Clearly, this is no time for massive

government programs which might or might not be successful in helping to preserve these resources. What is needed is an incentive which will involve a minimum of government involvement and a maximum of individual initiative, one that is modest in cost and limited in scope but that can spark broad private activity. The National Trust believes that H.R. 1662, introduced by Representatives Clay Shaw and Barbara Kennelly, and co-sponsored by 74 House members, is a fair, feasible and effective answer.

H.R. 1662 is designed to work in a broad range of contexts; each community is likely to find its own applications. For example, in many of the small towns of New England and the Midwest, older housing that would qualify for the credit has suffered from blight and abandonment as the mills and retail businesses upon which those communities depended declined and closed. Enterprising developers could buy up abandoned homes, rehabilitate them so as to qualify them for the credit, and sell them to young families, passing on the credit to the purchaser. These families might prefer living in a renovated older home in town, with the amenities of an earlier era and the convenience of in-town living. The result would be new life for the town, new customers for the town's small businesses, and new tax revenues for the town's hard-pressed treasury.

At the other end of the spectrum, many cities, large and small, possess older office buildings that would qualify for the credit, but which can no longer attract commercial tenants. Many of these buildings are architectural assets, but without an economic function they are targets for the wrecking ball. However, a federal homeownership credit could make these buildings economically attractive to a developer who could rehabilitate them as residential condominiums. The developer would, in effect, be selling the unit along with the credit. In this way these buildings could be saved, and the homeowners attracted to them would provide new customers for local merchants and new taxpayers for the city.

Major Provisions of H.R. 1662

Rate of Credit:

The credit, which would equal 20% of qualified rehabilitation expenditures, would be available to homeowners in condominiums and cooperatives as well as single-family homes. It could be used by the do-it-yourself rehabber, or someone who purchases a home rehabilitated by a non-profit or for-profit developer. In the latter case, the credit would accrue not to the developer, but to the purchaser of the home.

Eligible Structures

The universe of buildings eligible for the tax credit is a limited one. Only buildings that are listed in the National Register of Historic Places, are contributing buildings in National Register Historic Districts or in nationally-certified state or local districts, or are individually listed on a nationally-certified state or local register would qualify. The National Park Service has estimated that slightly in excess of 800,000 buildings nationwide presently fall in those categories.

To insure that their historic character is preserved, buildings receiving the credit would have to be rehabilitated in accordance with the Secretary of the Interior's Standards for Rehabilitation. However, the bill provides that certification of compliance may be performed by states or even localities under cooperative agreements entered into with the Secretary of the Interior. In addition, the bill authorizes the states to charge processing fees, the proceeds of which would be used to fund the costs of processing the applications for certification.

Maximum Credit, Minimum Expenditures

The maximum credit allowable would be \$50,000 for each principal residence, subject to Alternative Minimum Tax provisions. Any unused portions of the credit could be carried forward until exhausted. As with the current credit, rehabilitation must be substantial--the greater of \$5,000 or the adjusted basis of an eligible building, with an except on for buildings in census

tracts targeted as distressed for Mortgage Revenue Bond purposes under I.R.C. Section 143(j)(1) and Enterprise and Empowerment Zones, where the minimum would be \$5,000. At least five percent of the qualified rehabilitation expenditures would have to be spent on the exterior of the building. In the event that the taxpayer fails to maintain his principal residence in the building for five years, the credit would be subject to ratable recapture.

Homeownership and Historic Preservation

Central to the American dream is the desire to own one's own home. But home ownership is more than just a personal goal; by giving residents a true stake in their community, it promotes the qualities of neighborliness needed to heal and revive threatened and decaying residential areas

The existing federal tax credit for historic rehabilitation is not available to homeowners, but applies only to commercial property or other property held for the production of income. H.R. 1662 fills that gap. Moreover, because the tax credit that H.R. 1662 would create is limited to persons who occupy the building for which the tax credit is claimed as their personal residence, there are no tax shelters, no "passive losses" and no syndications. Further, since the proposed legislation is intended not only to foster homeownership and encourage rehabilitation of deteriorated buildings, but also to promote economic diversity among residents and increase local ad valorem real property, income, and sales tax revenues, individual taxpayers would be eligible for the credit without regard to income.

Opportunities for Low and Moderate Income Home Buyers

There is a widespread misperception that historic districts are places where only rich people live. While it is true that some of the better known districts on the National Register have been rehabilitated by or for affluent people, it is equally true that the older housing stock in the United States tends far more to be occupied by the poor than by the rich. Indeed, according to an analysis of 1990 census data, 29% of the 8,700 National Register historic districts lie within or contain tracts with poverty rates greater than 20%, a proportion found among Connecticut's 300 historic districts as well

This legislation has been drafted to provide homeownership opportunities in rehabilitated historic buildings to Americans at all income levels. For those who do not have sufficient income to be able to use a tax credit, the bill creates a Historic Rehabilitation Mortgage Credit Certificate that can be used to reduce the interest rate on their mortgage loan. Instead of a tax credit that he could not use, a homebuyer could receive a certificate in the face amount of the credit. The homebuyer would transfer the certificate to the mortgage lender in exchange for a reduced interested rate on the mortgage loan. The bank could then use the certificate to reduce its own federal income tax liability, subject to Alternative Minimum Tax restrictions, passing along the benefits to the home buyer by reducing the interest rate.

A Hypothetical Example

Consider, as an example, a hypothetical home rehabilitated by a developer which qualifies for the credit. Assume that the home has a selling price of \$150,000 and contains \$100,000 in qualified rehabilitation expenditures. The credit on this home is \$20,000 (20% of \$100,000). This would more than cover a down payment of 10 percent on the home. In this case the credit would have the effect of reimbursing the home purchaser for the down payment. Although this example involves a developer, the credit could also be used by an individual homeowner to help defray the cost of rehabilitating his current or newly-purchased residence.

Costs and Benefits

The revenue implications of H.R. 1662 would be modest. The Joint Committee on Taxation has estimated the revenue loss to the treasury at \$446 million over a seven year period. Nevertheless the National Trust believes this proposal can make a real difference in communities all across the county-from decaying small towns to threatened big-city neighborhoods. This view

is shared by the United States Conference of Mayors, the National Association of Home Builders, the Delaware Bankers Association, as well as preservation, economic development, and citizen groups across the country. By providing an incentive for Americans at all income levels to invest in the rehabilitation of deteriorated buildings and become home owners in older neighborhoods and communities, a historic homeowner tax credit can provide the following benefits:

- saving invaluable historic resources, which would otherwise be lost through decay, abandonment and demolition.
- stabilizing and rescuing endangered communities through the infusion of new home owners, who will make a commitment to the enhancement of community life through their purchase of a home.
- providing cities and towns with the chance to strengthen their tax bases by attracting middle-income and more affluent residents.
- creating jobs and stimulating economic activity in areas where economic opportunities are

When preservation begins in a community, good things follow. H.R. 1662 is not a cure-all for ailling communities. Change for the better, if it is to come, will be incremental. It will result from decisions made by individual Americans, one family at a time. But H.R. 1662 can be a spark that ignites those private decisions to the benefit of our families, our communities, and our heritage as Americans. On behalf of the 265,000 members of the National Trust for Historic Preservation, 1 strongly urge the prompt enactment of this legislation.

Chairman JOHNSON. Thank you. I appreciate your testimony. Mr. Kelley, it is a pleasure to have you with us today.

STATEMENT OF RICHARD KELLEY, PRESIDENT, RSK CONTRACTORS, INC., SOUTH WINDSOR, CONNECTICUT, ON BEHALF OF NATIONAL ASSOCIATION OF HOME BUILDERS

Mr. Kelley. Madam Chairman, my name is Richard Kelley. I have headed a family-run business for the past 25 years in South Windsor, Connecticut. We build all types of housing, ranging from entry-level to moving-up to luxury, in the immediate Hartford suburban area. Our company is involved in every aspect of the development process, from the purchase of raw land to the development of property for both residential and commercial uses.

This afternoon, I have the fortunate opportunity to represent 185,000 members of the National Association of Home Builders. I will paraphrase in the next few minutes a report we submitted to

you.

I congratulate you also, Mrs. Johnson, for holding this hearing and giving us the opportunity to present our views from someone who works in the trenches day in and day out. We are also particularly pleased this hearing will address a number of provisions of the Internal Revenue Code which impede land development and, we believe, adversely impact housing affordability.

In this regard, by paraphrasing this morning, we will address several issues: The installment sales rules, the tax treatment of environmental remediation costs, the tax credit for rehabilitation expenditures, and the State tax preference for small businesses.

At the outset, I want to congratulate you for being the catalyst in the Congress, especially introducing H.R. 957, to modify the tax treatment for contributions in aid of construction. The Senate-approved version of H.R. 3448 would repeal the CIAC with respect to water and sewer companies.

Although this proposal was not included in the House-passed version, we ask you, the Representatives of the House, to please recede to the Senate portion of this issue when it is brought to conference.

I also note that the provision was passed by the House as part of the 1995 budget but subsequently vetoed by the President, but it does need to be addressed, and hopefully the House will see fit to look at the Senate version.

First I would like to talk about the installment sales treatment for unimproved residential lots. The current installment sales rules add undue complexity to land development and add significantly to the cost of housing.

Currently, landowners are reluctant to partner with developers because of the installment sales rules. Payment to the original landowner is often contingent upon final sales to the home buyers, which can delay the actual receipt of funds to that landowner for years. However, the installment sales restrictions can require landowners to pay taxes on funds not yet received and discourage them from participating in otherwise efficient transactions.

Further, the complexity of the installment sales rules excludes otherwise qualified land developers from the coverage. This is par-

ticularly evident with respect to the installment sales treatment of unimproved residential lots.

Developers like myself selling residential lots to individuals in the ordinary course of business may use the installment method to regain—to report gain from such sales if neither the seller nor the person related to the seller makes any improvements on the lot.

The existing law is unclear as to the definition of the term "unimproved." It is not clear how many common amenities may be constructed before that raw land that can be developed at some time in the future would be considered to have been improved. Additional clarification is needed to define the term "unimproved."

The legislative history of the Tax Reform Act of 1986 says that construction of common infrastructure items such as roads and sewers should not cause raw land to be considered improved.

From the available guidance, land developers find it difficult to determine which common amenities and infrastructure items would cause an individual lot to no longer be considered unimproved.

For example, in a multifamily complex, would the front gate or fencing be considered a common element? Would the construction of a golf course or community clubhouse cause the undeveloped lots to be considered improved within the meaning of the statute?

Without further clarification, these questions would undoubtedly lead to increased controversy and lawsuits. Clarification and relaxation of these rules will lead to more efficient land use as landowners will have greater flexibility in their paying taxes on income in the year in which it is received.

The second item we would like to address is the tax credit for rehabilitation. We certainly know what is happening to our cities across America. The use of the Federal tax incentives to encourage private investment in historic rehabilitation has probably been one of the most effective frontal programs to promote urban and suburban growth.

We would like to again thank you, Mrs. Johnson, along with other of your colleagues, for introducing H.R. 1662, the Historic Homeownership Assistance Act. NAHB believes that this proposal would enhance historic rehabilitation credit and benefit those who wish to restore their historic homes. It would provide much needed home ownership opportunities and stimulate the revival of decaying neighborhoods and communities by expanding the current historical rehabilitation credit to include buildings owned and occupied as a principal residence.

Promoting the use of existing homes will decrease the need for more development at the fringe of our urban areas. It will encourage rehabilitation of historically significant homes through the proposed tax credit which will increase the preservation of the current stock of homes. Rehabilitation will also increase employment in areas where the historic homes are located, which have more convenient work destinations for the disadvantaged workers in that city than the locations in new residential.

Third, I would like to address tax preference for small businesses. The present estate and gift tax laws operate to destroy family-owned businesses by imposing a tax upon the intergenerational transfer of the business at the worst possible time, the death of the principal owner of the business.

Even worse, a tax incentive from year to year because of inflation is not considered. Home building is dominated by small firms like myself which are very often family-owned and -operated. Our figures show within our organization, NAHB, 79 percent of the members are classified as small businesses, small builders, and 91 percent of those are either principal owners or sole owners.

We commend the proponents of H.R. 2190 that would eliminate the estate tax for each ownership interest of a family-owned business worth up to \$1.5 million. This much needed legislation would not only facilitate the transfer of building remodeling businesses to the next generation but do away with the need for many small business owned firms to be sold or forced out of business in order to pay estate taxes.

NAHB strongly urges you to enact this legislation. We cannot overemphasize the importance of some form of tax estate planning.

An alternate proposal would be to address our concern in retaining the existing unified tax, if nothing else works, at a gift tax rate schedule, but to increase the uniform tax and gift tax credit, as our numbers show, to a \$1.5 million value. The existing rate structure and credit would be applied to assets that are not part of the business interests. We have clarified that further in the testimony that we have given to you earlier.

Thus, we would urge you, in the alternative, if nothing else seems to be flying, to consider legislation which would increase and index for inflation the unified tax. That is so important for our 185,000 members. But we don't need to represent homebuilders when I say that. I could represent the local chamber of commerce, the local hardware store owner, the local pharmacy owner. It not only applies to 185,000 homebuilders, it applies to people all over America.

Once again, Madam Chairman, I appreciate the opportunity and feel very humble to sit before you until doing our presentation. Thank you for listening.

[The prepared statement follows:]

STATEMENT OF THE

NATIONAL ASSOCIATION OF HOME BUILDERS

Madam Chairman and Members of the Subcommittee:

My name is Richard Kelley and I head RSK Contractors, Inc., a family-run business in operation for more than twenty-five years in South Windsor, Connecticut. We build all types of housing ranging from entry level homes to "move-up" and luxury homes in the immediate Hartford suburban area. Our company is involved in every aspect of the development process from the purchase of raw land to the development of property for both residential and commercial uses.

On behalf of the National Association of Home Builders (NAHB) and our 185,000 members. I congratulate you for holding this hearing and appreciate the opportunity to present our views before your Subcommittee. We are particularly pleased that this hearing will address a number of provisions of the Internal Revenue Code which impede land development and lessen housing affordability.

In this regard, my testimony will address several issues — the installment sales rules. the tax treatment of environmental remediation costs, the tax credit for rehabilitation expenditures, and an estate tax preference for small business. At the outset, Madam Chairman, I would like to commend you for your steadfast support in removing tax policy barriers to housing affordability as evidenced by your introduction of H.R. 957 to modify the tax treatment of contributions in add of construction (CIAC). The Senate approved version of H.R. 3448, the Small Business Job Protection Act would repeal CIAC with respect to water and sewerage companies. Although this proposal was not included in the House approved version of H.R. 3448, we would ask that the House conferees recede to the Senate position on this issue when it is brought to conference. I note that this provision was passed by the House as a part of the vetoed 1995 Budget Act.

Installment Sales Treatment for Unimproved Residential Lots

Allowing the sale of unimproved land to be taxed incrementally as payments are received rather than entirely when a contract is signed allows land owners, developers and builders to plan land use more efficiently and to reduce the ultimate cost of homes to the customer. Land development has become a time consuming and expensive operation for many of the members of NAHB. Local regulations, anti-growth sentiments, environmental concerns, and difficult and complex financing arrangements have increased the cost of developing land into lots for home building. Many of our members are turning to the original land owner as a partner in financing, and developing, large subdivisions, planned communities and mixed-use developments.

NAHB believes the installment sales rules add undue complexity to land development and add significantly to the cost of housing. This is particularly evident with respect to the installment sale treatment of unimproved residential lots. As you are aware, dealers in real estate are generally prohibited from using the installment method for reporting sales or other dispositions. An exception to this prohibition applies to the installment sales of residential lots. Under I.R.C. section 453(1)(2)(B) dealers selling residential lots to individuals in the ordinary course of business may use the installment method to report gain from such sales if neither the seller nor any person related to the seller makes any improvements on the lot. A residential lot has been defined as a parcel of unimproved land upon which the purchaser intends to construct a dwelling unit for use as a residence by the purchaser.

Additional clarification is needed as to the definition of the term "unimproved". The legislative history of the Tax Reform Act of 1986 provides that, with respect to determining whether land is unimproved "a parcel of land is not to be considered improved or developed if it merely has been provided with the benefits of common infrastructure items such as roads and sewers." Tax Reform Act of 1986, section 811; <u>See also.</u> Temp. Treas. Reg. section 1.453C-8T. From the available guidance, land developers find it difficult to determine which common amenities and infrastructure items would cause an individual lot to no longer be considered "unimproved". For example, would the front gate or fencing of a "gated community" be considered a common element? Would the construction of a golf course or community club house in a development cause the undeveloped lots to be considered "improved", within the meaning of the statute? Without legislative clarification, these questions will undoubtedly lead to increased controversy and litigation.

The union of existing land owners with home builders and developers reduces the amount of borrowed funds that must be tied up, sometimes for years, while development proceeds. The reductions in borrowing costs can be passed on to home buyers. However, land owners are often reluctant to partner with developers and home builders because of the installment sale rules. Payment to the original land owner is often contingent upon final sales to the home buyers, which can delay actual receipt of funds for years. However, the installment sales restrictions can require land owners to pay taxes on funds not yet received and discourage them from participating in otherwise efficient transactions.

As a result, landowners are less likely to sell to builders on an installment basis. Landowners also seek higher land sale prices to compensate for the additional tax burden. Higher land costs and fewer willing land owner partners in new home building increases the cost of new homes and creates affordability problems for potential home buyers. Clarification and relaxation of these rules will lead to more efficient land use as land owners have greater flexibility in paying taxes on income to the year in which it is received.

Tax Treatment of Environmental Remediation Costs

The costs incurred in remediation of environmental contamination should be deductible in the same year they are paid and should not be required to be capitalized. We believe that Internal Revenue Service rulings in this area indicate that the proper tax treatment of environmental cleanup costs must be clarified legislatively.

Generally, the cost of incidental repairs that neither materially add to the value of property nor prolong its life, but keep it in an ordinarily efficient operating condition, may be deducted as a business expense in the year paid. The Internal Revenue Code requires that costs that materially add to the value, or substantially prolong the useful life, of property owned by the taxpayer, or that adapt property to a new or different use, must be capitalized and written off over a period of time.

Cleanup costs can be considered as expenses necessary to maintain a property in ordinary efficient operating condition. If a property is contaminated sufficiently to require significant cleanup costs, the effective value of the property during the cleanup phase is zero. The costs incurred to remove the contaminants are necessary to bring the property into an ordinary efficient operating condition. The cleanup costs do not materially increase the value of the property, but bring the property into a condition in which it can be marketed.

The current tax law does not provide for the deductibility of cleaning up property that is already contaminated when purchased. Property owners who were unaware of contamination or who are subject to new regulations or restrictions after purchase, may not be able to deduct clean-up costs in the year the costs are paid and may very well be required by the IRS to capitalize such costs and recoup them through amortization. Requiring cost amortization discourages holding property for sufficient time to plan and develop the property to its full potential. Also, requiring amortized costs encourages land owners to sell quickly in order to record the cost against income which further delays careful planning and orderly developments. NAHB believes that the tax law should stimulate and encourage abatement of health hazards in the Nation's housing stock.

We urge you to amend the Internal Revenue Code to allow environmental cleanup costs, such as for contaminated soil and groundwater, to be deductible in the year in which they are incurred and allow a current year deduction of costs for clean up of property that is already contaminated when purchased.

Tax Credit for Rehabilitation Expenditures

We would like to thank you, once again, Madam Chairman along with Representatives Clay Shaw (R-FL), Barbara Kennelly (D-CT), Jim McCrery (R-LA), Richard Neal (D-MA), and Richard Zimmer (R-NJ) for introducing H.R. 1662, the Historic Homeownership Assistance Act, which would provide for a 20 percent tax credit, up to a maximum of \$50,000 or, if the taxpayer should choose, a transferable mortgage credit certificate, for the rehabilitation of certified historic structures used as a principal residence by the owner. We commend you for your unwavering support for affordable housing and eliminating tax impediments to its creation.

NAHB believes that this proposal would enhance the historic rehabilitation credit and benefit those who wish to restore their historic homes. It would provide much needed homeownership opportunities and stimulate the revival of decaying neighborhoods and communities by expanding the current historic rehabilitation credit to include buildings owned and occupied as a principal residence. Not including an income cap with respect to principal residences would foster economic diversity within the buildings. By providing for a transferable mortgage credit certificate the bill would allow lower income taxpayers to use the credit to facilitate payment of acquisition costs. H.R. 1662 is a needed step in the right direction.

Promoting the re-use of existing homes will decrease the need for more development at the fringe of our urban areas. Encouraging rehabilitation of historically significant homes through the proposed tax credit will increase the preservation of the current stock of homes. Rehabilitation will also increase employment in the places where the historic homes are located, which are often easier work destinations for disadvantaged workers than the locations of new residential construction.

Estate tax preference for Small Business

The current estate and gift tax laws operate to destroy family-owned businesses by imposing a tax upon the inter-generational transfer of the business. Moreover, the economic impact of the tax increases from year to year because of inflation. Home building is dominated by small firms which very often are family owned and operated (79% percent of NAHB membership are classified as small builders and 91% are either principal owners or sole owners. NAHB Housing Economics, July 1995 p. 12). NAHB fully supports estate tax reform for small businesses.

The federal estate tax is imposed on the value of property passing at death. The estate tax rates begin at 18 percent on the first \$10,000 in taxable transfers at death and reach 55 percent on taxable transfers over \$3 million. The amount of estate and gift tax is calculated by multiplying the tax rate by the taxable transfers at death and subtracting the estate and gift tax credit which is currently \$192,800. This effectively exempts estates less than \$600,000 from taxation.

We commend Representatives Jim McCrery (R-LA), Jennifer Dunn (R-WA), Wally Herger (R-CA), L.F. Payne (D-VA), Mel Hancock (R-MO), Jon Christensen (R-NE), Greg Laughlin (R-TX), Jim Hayes (R-LA), John Ensign (R-NV), Jim Nussle (R-IA), Rob Portman (R-OH) and Mac Collins (R-GA) for having introduced legislation (H.R. 2190) which would eliminate the estate tax for each ownership interest of a family-owned business worth up to \$1.5 million. For business ownership interests over \$1.5 million, only one-half of the excess (the monies over \$1.5 million) would be tax-free and only \$2.50,000 would be tax-free and only \$2.50,000 would be taxed.

An alternative to H.R. 2190 would be to retain the existing unified estate and gift tax rate schedule, but to increase the unified estate and gift tax exemption amount to \$655.800 for each ownership interest of a family-owned business. This would effectively eliminate estate taxes on family-owned businesses valued at less than \$1,500,000. The existing rate structure and credit would be applied to assets that are not part of the business interest (as shown in the following diagram).

Exhibit			
Difference in Estate Tax Liabilities for			
Different Levels of Taxable Estates:			
Current Law vs. NAHB Proposal			
	Estate Tax Estimates		
Taxable	Current	NAHB	
Estate	Law	Proposal	
\$600,000	\$0	\$0	
700,000	37,000	0	
800,000	75,000	0	
900.000	114,000	0	
1,000,000	153,000	0	
1,500,000	363,000	0	
2,000,000	588,000	125,000	
2.500,000	833,000	370,000	
3,000,000	1,098,000	635,000	
Over 3 million	\$1,290,800 +	\$635,000 +	
	55% of excess	55% of excess	
	over	over \$3,000,000	
	\$3,000,000		
NAHB ECONOMICS		12 July 1996	

As mentioned above, the majority of NAHB's members are small businesses, many of which are family owned. H.R. 2190 would eliminate, or significantly lower, the estate tax on most family-owned building/remodeling firms. This much needed legislation would not only facilitate the transfer of building/remodeling businesses to the next generation, but would do away with the need for many small family-owned building and remodeling firms to be sold or forced out of business in order to pay estate taxes. H.R. 2190 would provide much needed, and long awaited, relief from the estate tax for our members. NAHB strongly urges you to enact this legislation.

In the alternative, significant estate tax reform is urgently needed and we would urge you to enact legislation which would increase, and index for inflation, the unified credit.

CONCLUSION

NAHB urges you to pass these legislative proposals as soon as possible. Enactment of these proposals would simplify the tax laws, establish good tax policy and benefit out national economy. I would be pleased to answer any questions you might have.

Chairman JOHNSON. Thank you for your excellent testimony with a variety of suggestions. It is an issue that we are very concerned with, not only in the agriculture community but in the small business community.

Mr. MacEwen.

STATEMENT OF BRUCE W. MAC EWEN, VICE PRESIDENT, TAXATION, PORTMAN HOLDINGS, L.P., ATLANTA, GEORGIA, ON BEHALF OF NATIONAL REALTY COMMITTEE

Mr. MACEWEN. Chairman Johnson and Members of the Sub-

committee, good afternoon.

My name is Bruce MacEwen. I am vice president of taxation of Portman Holdings, a national firm headquartered in Atlanta, which owns, manages, and develops office, retail, and hotel properties throughout the United States as well as in several foreign countries.

I am here today on behalf of the National Realty Committee, where I serve as vice chair of its tax policy advisory committee. My testimony will focus on how the current tax law discourages businesses from investing in and redeveloping land located in the urban centers of our country.

A number of these provisions are detailed in our written statement, but I would like to highlight three key areas of tax policy: Cleaning up contaminated land, demolishing and redeveloping abandoned structures, and modernizing and reconfiguring existing

commercial space.

First, the cleanup of contaminated land and structures adds to the cost of the redevelopment project, often significantly. Depending on the extent and type of contamination, these costs often reach into the tens of thousands of dollars, and sometimes millions. In most areas of the country, but particularly in central city areas, adequate financing to carry out both cleanup and development activities is not available at affordable costs. Owners and lenders are concerned not only about the costs and risks but also about liability.

Additionally, cleanup requires time and delay, further increasing up-front costs which affect the ultimate profitability of a project. Therefore, the tax laws relating to cleanup expenses are of vital im-

portance to the project.

At present, the tax laws in this area offer no incentive to invest in and clean up contaminated land versus clean, previously undeveloped land. Instead, these cleanup costs must be added into the basis of the land itself, meaning that they are not recoverable through depreciation.

A provision to spur the cleanup of so-called "brownfields" by allowing purchasers to immediately deduct the cost of cleaning up contaminated land in Federal empowerment zones and enterprise communities has recently been proposed by Congressman Rangel. We applaud him and others for recognizing part of this larger problem

However, we would urge that the concept of providing a tax incentive for the cost of cleaning up acquired contaminated land not be confined solely to targeted empowerment zones. If immediate deductibility is provided for targeted areas, then, at a minimum,

some rapid writeoff period should be established for nontargeted

areas, perhaps 5 years.

The second area I want to highlight concerns the demolition and redevelopment of abandoned nonhistoric structures, a situation more likely to occur in urban rather than suburban areas. Since 1984, all demolition costs for nonhistoric buildings must be added to the basis of land rather than deducted. This discourages the acquisition of land on which there is a building which must be demolished in order to use the land more productively. We propose a return to pre-1984 treatment of demolition costs.

Finally, the long cost recovery period associated with the modernization and reconfiguring of existing commercial space in urban areas discourages the revitalization of buildings and the reuse of land in America's cities. Instead of the building owner recovering the expenses incurred to construct so-called leasehold improvements over the life of the improvement, today's rules dictate that such expenses must be recovered over the life of the overall building which is now depreciated over 39 years. Seldom do tenants sign

leases of 39 years or more.

Compounding this, significant ambiguity surrounds how a real estate owner accounts for leasehold improvements that are demolished before the end of the recovery period in order to make way for a new tenant. To address this so-called closeout problem, we are supporting a provision first introduced by Congressman Shaw and other distinguished Members of your Committee and included in the Senate version of the Small Business Jobs Protection Act. We strongly urge House support of this provision in conference with the Senate.

Let me state in closing, we believe that a more reasonable policy must be established for the costs of cleaning up contaminated land, perhaps a more generous incentive in targeted areas, but an incentive in nontargeted areas as well. We believe the tax treatment of demolition expenses should be revised.

Finally, we urge the House to accept the leasehold improvements provision contained in the Senate version of the Small Business Jobs Protection Act. These actions would, without a doubt, help generate jobs and maintain commercial real estate asset values and, as a result, help restore and stabilize the health of our urban centers.

Thank you very much.

[The prepared statement follows:]

STATEMENT OF THE NATIONAL REALTY COMMITTEE

TO THE SUBCOMMITTEE ON OVERSIGHT

OF THE COMMITTEE ON WAYS AND MEANS

U.S. HOUSE OF REPRESENTATIVES

REGARDING

TAX LAW AND LAND USE

Bruce W. MacEwen Vice Chairman Tax Policy Advisory Committee National Realty Committee

July 16, 1996

Introduction

Congresswoman Johnson, members of the Subcommittee on Oversight of the Committee on Ways and Means, good afternoon. My name is Bruce W. MacEwen, and I am Vice Chair of the Tax Policy Advisory Committee of National Realty Committee (NRC).

NRC serves as Real Estate's Roundtable in Washington on national policy issues affecting real estate. NRC's members are America's principal commercial and multifamily real estate owners, advisors, builders, investors, lenders and managers. Portman Holdings, L.P., where I serve as vice president of taxation, owns, manages and develops office, retail, residential and hotel properties throughout the United States as well as in several foreign countries. It is because of NRC's significant concern with policies that affect our nation's communities and cities, and because of Portman's vast experience in committing substantial investment in America's cities (primarily downtown centers), that I am here today to present testimony regarding the impact of the federal tax law on land use.

As noted in your release announcing these hearings, there presently exists a number of tax provisions which may have unintended consequences for land use. In particular, I'd like to offer NRC's views and recommendations on that aspect of your Committee announcement that concerns those provisions of current tax law that may act to discourage businesses from investing in urban areas — not only in vacant urban land, but in developing or redeveloping any structure on such land necessary for job and economic growth to occur.

Clearly, business investment decisions concerning urban areas are not driven by federal tax policy alone. A more complete picture also would require inquiry into a number of other major sets of circumstances including efforts to control crime as well as the interplay of local governance, transportation issues, and the role of independent public authorities in regional development. Nonetheless, federal tax policy can play a significant role in affecting business investment in our nation's cities. We therefore welcome the opportunity to explore this interplay with the Subcommittee; and, we look forward to working with you, Congresswoman Johnson, and members of the Subcommittee, as you continue your work in this area.

Summary

National Realty Committee believes that federal tax policies should serve as neither an incentive to unjustifiable, excessive real estate investment, nor as a distincentive to prudent, needed investment which would benefit our nation's communities, including urban areas. Indeed, as we all witnessed during the drastic decline in real estate values in the early 1990s, America's cities, taxpayers, and savers all have a stake in rational, growth-oriented real estate tax policy and sound real estate asvet values. Today, commercial and multifamily real estate asset values generally continue to rebound slowly from the substantial real estate asset devaluation that occurred earlier this decade. Notwithstanding these national market conditions, in many local markets the real estate recovery is still fragile, if not precarious, leaving many cities and counties with less than optimum land use as well as reduced property tax revenues and public services.

As explained in greater detail in this statement, a number of provisions in the current tax law act to reduce the relative appeal of urban land as a development investment alternative and tend to hold previously used urban land below its optimum use. Chief among these provisions are those that:

- discourage the acquisition and development of vacant land in urban areas through the lack of any recovery of costs associated with cleaning-up environmentally contaminated land;
- discourage the redevelopment of existing structures in urban areas due to the high cost of removing and replacing potentially hazardous materials such as asbestos and the apparent governmental view that in most cases such costs should be capitalized as a long-term improvement rather than deducted as a repair;
- discourage the modernization and reconfiguration of existing commercial space in urban areas due to the excessively long cost recovery rules associated with constructing improvements to the structure to accommodate the needs of office and retail tenants;
- require many development costs to be considered acquisition costs therefore requiring such
 costs to be capitalized into the basis of the land rather than added to the depreciable basis of
 the developed building; and,
- discourage demolition and redevelopment of abandoned structures by requiring that
 demolition costs, as well as the cost of the demolished structure itself, be added to the
 nondepreciable basis of land rather than added to the basis of any replacement structure and
 recovered through depreciation.

It is also worth noting that the existing tax incentives designed to entice businesses to locate in empowerment zones (an employment and training credit, an additional expensing allowance, and the recent addition of a new category of tax-exempt private activity bonds) do not provide any additional incentive to invest in the nondepreciable land (contaminated or not) or the depreciable structure necessary to house and operate the business intended to locate in the empowerment zone. This deficiency may substantially influence certain investment decisions in empowerment zones.

Discussion

Environmental Remediation Expenses

In National Realty Committee's view, one of the more significant aspects of the current tax law which discourages businesses from investing in urban areas concerns the tax treatment of environmental remediation expenses. There are two specific examples which immediately come to mind. These concern the lack of clear guidance regarding the recovery of costs associated with cleaning-up environmentally contaminated urban land (including the so-called urban "brownfields"), as well as uncertainty concerning the tax treatment of the costs related to removing hazardous materials from existing buildings.

While this issue can also affect suburban properties, typically remediation issues are more costly in urban land settings.

Since the enactment of the Comprehensive Environmental Response, Compensation and Liability Act (1986), the Resource Conservation and Recovery Act (1976) and the Toxic Substances Control Act (1976), real estate owners have become responsible for remediating a variety of different types of hazardous materials. During the same time period, market conditions also increasingly required the clean-up of real and perceived environmental hazards. Although the tax treatment of the clean-up of such environmentally hazardous situations was generally thought to be deductible, beginning in 1992, through a series of Technical Advice Memoranda (resting largely on the question of whether the clean-up expense increased the value of the asset), the Internal Revenue Service has interpreted case law in a manner that has seemed to require a vast number of such expenses to be capitalized as an improvement, rather than deducted as a repair.

The present state of the law regarding land clean-up expenses is murky at best. It now seems that an owner of land that was not contaminated at the time of acquisition may deduct certain — but not all — of the costs incurred to remediate contamination occurring during the period of ownership. However, IRS officials have stated that costs to remediate land purchased in a contaminated state, including land purchased with underground storage tanks, must be capitalized and added to the basis of the non-depreciable land. This aspect of the current tax law cries out for clarification of the proper tests that will ensure that costs incurred to clean-up contaminated land are deductible.

Partially addressing this issue, the Administration included in its most recent budget proposals a proposal to spur the cleanup of so-called "brownfields" by allowing new purchasers

and other businesses a targeted tax incentive to recover certain costs to remediate environmentally contaminated brownfields properties. (The term brownfields generally refers to certain abandoned, contaminated industrial or commercial properties that are less toxic than Superfund sites, but still face barriers to their redevelopment.) The tax incentive (immediate expensing) is proposed to apply to the cleanup of brownfields in high-poverty areas, existing Environmental Protection Agency brownfields pilot areas, and federal empowerment zones and enterprise communities. Legislation (H.R. 3747) embodying this concept was recently introduced by Representative Rangel. While supportive of this approach (which should be extended to non-targeted areas as well), we also believe that any efforts in this area also must include non-tax related provisions that provide certainty to real estate owners and lenders regarding potential liability for the costs of cleaning up hazardous materials on their property. Protection from liability also should be provided to owners where contamination occurs by the disposal of hazardous materials by owners or users of contiguous property. Greater investment in our nation's urban land is much more likely to occur when investors and lenders can be confident that they will not expose themselves to unwarranted liability, and where the tax laws applicable to environmental remediation do not act as a deterrent or disincentive to needed cleanup up operations.

We would urge that the "brownfields" concept providing an immediate tax deduction for the costs of cleaning up acquired contaminated land in targeted areas be extended to non-targeted areas as well. If not immediate deductibility, than some rapid amortization period would seem appropriate for non-targeted areas.

On the issue of the deductibility of costs associated with remediation of potentially hazardous materials in existing structures (such as asbestos), great uncertainty regarding whether such costs are capitalized or deducted also has developed. Because many buildings located in urban areas may contain potentially hazardous materials such as asbestos, and therefore due to market perceptions may need to be remediated, this issue could significantly deter investment decisions in urban areas. We would urge that the Internal Revenue Service provide guidance in this area to simply restate the law regarding repair expenses as it clearly existed prior to the IRS releasing the related TAMs beginning in 1992 — that is, that the repair doctrine presented in the Tax Court's decision in Plainfield-Union Water Company is correct law. This case held that for purposes of determining whether an expenditure increases the value of property and, therefore, must be capitalized, the proper comparison is between the value of the property after the expenditure and the value of that property before the condition requiring the expenditure. This would help to ensure that the costs associated with remediating asbestos in long-held properties would be deductible repairs.

Most important in this area of environmental cleanup costs is that the current law: 1) provides no clear incentive to clean-up; and, 2) requires compliance with burdensome regulations. These factors have a significantly negative effect on investment in land, especially in urban areas.

Land Development Expenses

Some have noted that the current cost recovery provisions discourage businesses from investing in urban areas because, while plant or equipment can be depreciated, the land on which a structure is built cannot. This is said to encourage non-urban investment where land costs are lower, therefore allowing a greater portion of the investment to be recovered through a depreciation allowance. This factual point is amplified when one considers that: 1) land costs are currently not recoverable for tax purposes, therefore significantly reducing its appeal as an investment; and, 2) the amount of investment in land development which must be capitalized has increased dramatically over the past 20 years, making a greater portion than ever of development costs either not recoverable at all, or recoverable over a substantially longer period than its economic useful life.

Clearly, tax treatment that capitalizes a greater and greater portion of land development costs tends to discourage investment in higher cost urban areas. Here are a few examples of this troubling trend:

- IRC Section 280B, added to the Code in 1976 and expanded in 1984, requires that demolition
 costs, as well as the cost of the demolished structure itself, must be added to the basis of land
 rather that deducted. This tends to discourage the acquisition of land, including a structure
 which must be demolished in order to construct a more suitable physical plant, because the
 costs of demolition are not recovered until the underlying land is disposed. A more
 appropriate tax result would permit depreciation of demolition costs.
- IRC Section 189, which permitted a 10 year amortization of construction period interest and taxes, was repealed in 1986. The result is that such expenses now must be added to the basis of the building being constructed and depreciated over a straight-line basis, generally 39 years for nonresidential property. Thus, the capital recovery period for construction period interest and taxes has jumped from 10 years to 39 years since 1986.

- Section 263A, relating to the capitalization of construction period expenses (e.g., interest, taxes, insurance), was added to the Code in 1986 and final regulations were promulgated in 1994. In general the effect of these rules is to greatly increase the amount of interest and taxes which are required to be capitalized (and recovered on a straight line basis, generally 39 years). For example, commencement of construction of common improvements such as feeder roads are deemed to start the capitalization "clock" as to all phases of construction benefited by such improvements even if construction of a given phase of development is years off. This provision also adopts the "avoid cost" method of capitalizing interest which requires a taxpayer to reallocate interest expense to construction from loans used for unrelated purposes even when it can clearly be demonstrated that a given land purchase or construction activity was funded with equity not debt. In effect, the rule requires a taxpayer to impute interest expense to construction expenditures funded by his own equity if his balance sheet has any debt whether or not such debt is related to the development.
- Beginning in 1981, and revised in 1984 and 1986, land improvement costs such as those
 incurred for landscaping and surface parking lots were required to be recovered over an
 arbitrary period much longer than their economic useful life currently the statutory period
 is 15 years. In a commercial context, such improvements as roads and surface parking have
 much shorter useful lives generally between 5 and 7 years.

We would urge a comprehensive review of the tax laws concerning the capitalization of land development expenses, including demolition expenses (which at a minimum should be added to the basis of the replacement structure and not to the nondepreciable land).

Leasehold Improvements

Today's tax policy governing the recovery of costs associated with constructing leasehold improvements (internal walls, ceilings, partitions, plumbing, lighting and finish) misstates economic reality, and as such inhibits employment opportunities, discourages environmentally efficient building improvements and discourages the revitalization of America's cities. Instead of a building owner recovering the expenses incurred to construct leasehold improvements over the life of the constructed leasehold improvement, today's rules dictate that such expenses be recovered over the life of the overall building, which is now depreciated over 39 years.

Compounding one problem (regarding the unrealistic time period over which leasehold improvement costs are required to be recovered) is another problem — significant ambiguity surrounding how a real estate owner accounts for leasehold improvements that are demolished before the end of the prescribed recovery period, in order to make way for a new tenant. Prior to 1981 it was clear that an owner could deduct the remaining unrecovered cost in the year in which the improvement was demolished. Beginning in 1981, and certainly since 1986, whether the owner has retained this ability is unclear in many circumstances.

What's the fallout of today's flawed policy in this area? To begin with, the after-tax cost of reconfiguring, or "building-out", space to accommodate a new tenant is artificially high. Because the owner is unable to fully deduct the economic costs expended on leasehold improvements over the improvements' useful life, the owner's income is artificially inflated for tax purposes. To make matters worse, the current policy hinders urban renewal and construction job opportunities as improvements are delayed or not undertaken at all. Like factories in need of retooling so they can produce the most advanced kinds of products, many buildings today need to be retooled to provide the environment necessary to house and grow businesses of the future.

Historically speaking, the concept of economic cost recovery is fundamental to the integrity of America's tax system. True net income is determined by recovering the costs expended on an investment over the same period of time as the investment earns income. This "matching" precept has long been embedded in the tax code. Prior to the Economic Recovery Tax Act of 1981 ("1981 Act"), a building owner was generally entitled to recover the costs associated with constructing leasehold improvements over their useful lives, such as the term of the lease for which they were constructed. Appropriately, this policy reflected the fact that improvements constructed for one tenant are rarely suitable for another, and that when a tenant leaves, the space is typically built-out all over again (or at least substantially renovated) for a new tenant. With the 1981 Act, however, the concept of matching income from the lease with the costs of leasehold improvements was set aside as the system of component depreciation for real estate was abandoned.

In an effort to simplify depreciation laws, a single depreciation life of 15 years was established for buildings and leasehold improvements made to them by owners.

Since the 1981 Act, however, the recovery period for nonresidential real property has been lengthened to 39 years. With these depreciation changes, however, has come no distinction between the capital cost recovery of buildings themselves and the periodic internal improvements made to accommodate specific tenants.

Thus, in the relatively short time between 1981 and 1986, the tax treatment of leasehold improvements dramatically changed from a flexible depreciation system that sought to accurately match income with expenses to a system that dictates a recovery of expenses over a period that in no way reflects the useful life of these improvements. In light of this situation, now is an opportune time to revisit and modify these rules, which over time have been increasingly problematic.

To address this important tax problem NRC is pleased to endorse a provision approved last year as part of the balanced budget tax legislation which would have clarified that building owners may fully deduct and close out any unrecovered leasehold improvement expense remaining at the time the tenant improvement is destroyed. This provision is now included in the Senate version of the Small Business Jobs Protection Act and we strongly urge House support for the provision in Conference with the Senate. Additionally, House legislation (H.R. 1171) has been introduced by Ways and Means Committee members E. Clay Shaw, Jr. (R-FL) and Charles B. Rangel (D-NY) to reduce the recovery period for certain tenant improvements from 39 to 10 years. This legislation would be a significant step in the right direction of more accurately matching income with expenses.

Empowerment Zones

In 1993, a series of special federal income tax provisions was enacted to expand business and employment opportunities in a limited number of qualifying economically distressed urban and rural areas throughout the country (empowerment zones). Among these special tax incentives were provisions to provide an employment and training tax credit, an additional \$20,000 per year in section 179 expensing, and a new category of tax-exempt private activity bonds. At the time these rules were enacted, and still today, we believe that in order to significantly increase the economic activity and job growth in these targeted areas requires an investment incentive for expenditures incurred in connection with the acquisition, rehabilitation or reconstruction of any nonresidential building located in these qualifying empowerment zones. While recent Administration proposals and Representative Rangel's legislation (H.R. 3747) propose to provide tax assistance to clean-up certain hazardous waste in empowerment zones, consideration should be given to encourage investment in non-contaminated land as well.

Conclusion

National Realty Committee appreciates the opportunity to comment on the current tax provisions which we believe needlessly discourage investment in urban land and cities. We believe that the provisions relating to the tax treatment of environmental remediation are in serious need of clarification so that investment is not discouraged due to the inability to recover clean-up costs. At the same time, the tax treatment of demolition expenses should be reviewed, and attention should be paid to the compounding effect of rules requiring more and more land development costs to be capitalized. Most important, in today's debate, we urge members of the House to accept the Senate provision on leasehold improvements which is contained in the Senate version of the Small Business Jobs Protection bill, and consider adopting a shorter time period in general for leasehold improvements along the lines of the Shaw-Rangel bill. These actions would, without a doubt, help generate jobs and maintain commercial real estate asset-values and, as a result, help urban areas grow.

Thank you.

Chairman JOHNSON. I thank the panel for your excellent testimony.

We are very concerned with the tax impact of some of these things, the cleanup costs. I was not aware of the demolition issue on urban areas and on land use in urban areas. There are many appropriate areas in our cities that should be used again for com-

mercial purposes rather than commerce moving out to some of the more rural areas, and part of protecting our rural areas is enabling land in inner cities to be used for its historic commercial purposes.

I appreciate your testimony on these issues.

There is broad bipartisan interest in enterprise zones, as now both the administration and Mr. Rangel have proposed and a number of Republicans have proposed and are supporting the Talent-Watts bill. I would like your thoughts on the impact of selective benefits for specific areas as opposed to tax changes that are more comprehensive. In other words, do you have any thoughts on those enterprise zones?

Mr. MACEWEN. I think my position would be that we certainly favor the enterprise zone concept. The benefits, I think, are well directed. I also think that the enterprise zone concept can be expanded into a broader perspective to address some of the issues that my comments addressed.

Chairman JOHNSON. Thank you.

Anyone else? Any comment on enterprise zones?

Mr. Kelley. I think the history of the enterprise zone is a good format, Congresswoman. It could be expanded into other areas, using that as a base for experience. It does work around the country, no question about it.

Chairman JOHNSON. Ms. Osterman, your testimony mentions that the passive loss and income restrictions imposed in the 1986 tax reform act have limited the impact of the rehabilitation credit.

Could you enlarge on that?

Ms. OSTERMAN. The 1986 act severely restricts the ability of investors to utilize real estate losses to offset taxes on ordinary income. That has been the principal effect on the desirability of utilizing the existing rehabilitation tax credit.

Other changes in the tax act that are important are the reduction of the credit from 25 to 20 percent and also income restrictions that basically make it very difficult for individuals with incomes

above \$250,000 to utilize the credit as investors.

I would like to point out to the Chairman, to the Subcommittee, that the passive loss limitations and income caps and other provisions that currently prevail over the existing rehabilitation tax credit would not apply under the proposed historic home ownership tax credit, because that would not be an investor tax credit but would be used for a principal residence. This would not be subject to any of those kinds of limitations.

Chairman JOHNSON. I understand. Thank you.

Mr. Kelley, in your presentation you talked extensively about installment sales treatment of unimproved residential lots. You make the point very effectively that rules can be very costly and complicated. What impact do these rules have on decisions about where to build?

Mr. Kelley. Mrs. Johnson, it has a tremendous impact. Personally, we are dealing with a property owner now which happens to be in a farming area of about 65 acres. When we approached the farmer—he is well into his eighties now—about working with us as a partner, of taking his farmland and letting us only take one piece of it and turn it into housing, and using the vast majority of it to turn into a community park, for him to take a tax credit, when his accountant and attorney got through with it, that idea was immediately thrown out, because their concern was, the only way that this person could do that, the landowner, would be to create a charitable trust, put that land, the profit, into the charitable trust.

But their problem was, when is the charitable trust going to be funded? I said to them it is impossible to fund it up front, so you have got to fund it over a course of 2 or 3 years when we build the houses. Their concern, the accountant's concern was, he is going to

have to pay taxes on money that he doesn't have.

My idea is, if Congress could take a look at what we are talking about, let us have some input, since a lot of us are in the trenches and are doing this all the time, that land use and land development in the years to come will look much different than it has in the past.

We, because of haste—and I am as guilty as others—because of haste, because of some of the restrictions we have, the land use probably would have been better off if we had slowed down, if we could have, and taken the time and done something a little different

The tax credit means installment sales, just like environmental. A portion of this person's property, we are concerned, it has contaminants on it. If there is, does the law permit him or would the law even permit me to clean up that portion of that 67 acres that has the contaminants on it and take it off the cost of that land? Or would he or I have to put it over a schedule for 20 or 30 years? It depends on what we put on to that piece of contaminated land.

That is why we are sitting before you this morning, saying to Congress, saying to Representative Hancock and Mrs. Johnson sitting here listening to us, that things have got to change, that we all have to be a part of it in order for those things to change in the future.

Chairman JOHNSON. That is a very interesting point you make about taking the cleanup costs off of the land.

Mr. Kelley. Did I answer your question?

Chairman JOHNSON. Yes, thank you.

Mr. Hancock—whose plane just got in a few minutes ago—I am glad to have you.

Mr. HANCOCK. This is a subject that I have been very interested in for some 25 years or more.

There is a theory out there that some people say is even more important than the way the Federal tax applies to the development of real estate, called land value taxation. Are you familiar with that term?

Mr. Kelley. No, I am not, sir.

Mr. HANCOCK. As you know, one of the things, the theory is anyway, that has caused urban blight was the skipping over of big areas and going out and buying rural land and holding it until the

city or development comes to it. The theory is to calculate the real estate tax, which has a big bearing on these decisions, on the value of the location rather than the value of the improvements—evidently you are not familiar with it at all.

The theory was developed back in the twenties. It happened to be by an economist by the name of George at the University of Missouri. You might want to look it up, take a look at it. It is called

land value taxation.

The theory is that we would have never suffered the urban blight if, in fact, property was taxed on the true value of the land. In other words, the tax structure would provide an incentive to improve urban land so that it would be used for its highest or best use. You could not buy a piece of property and let it run down because you are going to get taxed as if you had developed the property.

So I would suggest you take a look at it and maybe incorporate it in part of your work toward providing reasonableness in the Fed-

eral Tax Code pertaining to real estate and development.

Mr. KELLEY. I will. Thank you.

Mr. HANCOCK. Thank you, Madam Chairman.

Chairman JOHNSON. Mr. MacEwen, you suggested really a number of different changes that are, each one, important. But if you had to help us target our actions, because we never can do all the things we believe are most important, what areas do you think are most important for us to attend to?

I guess I would open this up to all of you.

Mr. MacEwen. Changes in the tax law regarding leasehold improvements are very close to fruition and have bipartisan support in both Houses of Congress. Again, the provision will be an issue in the Conference Committee.

With respect to the Business Jobs Protection Act, this is an issue that I think is very important to the development of commercial

real estate and establishing reasonable tax policy thereon.

For years, with the frequent changes in the depreciation period, we have seen the depreciation of leasehold improvements go from over the life of the lease, which may be as short as 5 years, all the way up to 39 years now, from 1981 through current law. We have seen a lot of changes.

Thirty-nine years is too long to depreciate a leasehold improvement, where, in the real market today, our leases are 5 years—usually from 5 to 10 years, after which time we have to tear out those improvements and replace them. We are not allowed necessarily to write off those costs today. We have to keep those on the books for 39 years.

This provision, which will come up in conference, will clarify this and would permit a current deduction. So that one is very close to

fruition.

The other issues, regarding cleanup and demolition costs, are issues that have been in the forefront now for the last few years with the advent of the asbestos problem. The Service has taken different viewpoints with respect to the deductibility of those costs.

We think there is case law that supports treatment of remediation expenses as repairs because it does not enhance the value of the property, it only restores the property to its previous value.

This doesn't necessarily suggest a legislative fix, but we think the Congress should consider this and look into it.

As far as demolition costs are concerned, these were changed in 1984. Prior to that, you could deduct the cost of a building you demolished. We think a return to pre-1984 tax policy is appropriate and would be particularly helpful in revitalizing America's urban centers, which, as we know, as they deteriorate, tend to be a catalyst for crime, it exacerbates the homeless problem, and we all believe that the revitalization and the maintenance of vital urban centers benefits our communities as a whole.

Chairman JOHNSON. Thank you very much.

Mr. Kelley. We homebuilders could offer a lot of assistance in this areas because that is one of our issues. The contribution in aid of construction, in the old heydays, when you could go out to a bank and borrow money for any rehabilitation you wanted to do, wasn't so bad over a number of years. But when you are coming up with your own money, aiding someone else's expenditures, it makes a big difference. We could offer a lot of assistance. We have done a lot of work on this aspect. We could participate in that with you if you wish.

Chairman JOHNSON. Thank you.

Mr. MACEWEN. I would like to thank the Members of your Subcommittee as well as the entire Ways and Means Committee for the support of the leasehold provisions, in particular Congressman Shaw who introduced the bill and had several cosponsors.

Chairman Johnson. In preparing for this hearing, I think it is fair to say all the Members who testified, and the Members of the Subcommittee, have been impressed with how many provisions there are in the Tax Code, what a scatter shot pattern they have in terms of a public policy, how important it is to really understand far better the implications of the current impact of tax law on land use decisions and land preservation decisions as well as proper development decisions.

It is interesting that you could even work with the farmer to develop land in a way that would be respectful of our conservation needs as well as his economic needs, because of a variety of problems in the tax law.

So we do hope to straighten out some of the problems in the tax law and support some of the initiatives that the Members have offered. And then there are a number of other areas that you suggested and brought to our attention that we appreciate.

Our goal overall, not all to be accomplished this term certainly, is to provide a better comprehensive structure within which to look at land use proposals, but also to develop a more integrated land use policy for the Nation.

Thank you very much for your participation, I appreciate your preparation, and for your help at this point in the process, and I know for your continuing help as we move through this. Thank you very much.

[Whereupon, at 1:30 p.m., the hearing was adjourned.]

[Submissions for the record follow:]



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FOR IMMEDIATE RELEASE July 16, 1996

STATEMENT BY TREASURY SECRETARY ROBERT RUBIN ON THE PRESIDENT'S BROWNFIELDS TAX INCENTIVE AND EMPOWERMENT ZONE PROPOSALS

Today, the Ways and Means Oversight Subcommittee will be considering tax incentives to encourage cleanup and redevelopment of contaminated and economically distressed sites. Earlier this year, President Clinton called for such an incentive in his State of the Union address and included this initiative, fully paid for, in his FY 1997 budget.

The President's brownfields tax incentive will spur the cleanup and redevelopment of thousands of contaminated sites, and together with the new Empowerment Zone and Enterprise Community proposal, will help to rebuild neighborhoods, create jobs, and restore hope to our nation's cities and distressed rural areas.

I thank Congressman Rangel for introducing H.R. 3747, containing the President's brownfields tax incentive and Empowerment Zone proposals, and Senators Moseley-Braun, Jeffords and D'Amato for introducing a companion measure, S. 1911, in the Senate. The Administration strongly urges the Oversight Subcommittee to favorably consider these proposals.

RR-1173

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Background

Under the President's brownfields tax incentive, environmental cleanup costs would be fully deductible in the year in which they are incurred -- a significant incentive that would reduce the cost of capital for these types of investment by more than half. The \$2 billion incentive is expected to leverage \$10 billion in private investment, returning an estimated 30,000 brownfields to productive use. The incentive would be available in 40 of the existing EPA Brownfields pilot areas, in areas with a poverty rate of 20 percent or more, in adjacent industrial or commercial areas, and in Empowerment Zones and Enterprise Communities, both existing ones and those that would be designated in the second round.

The Clinton Administration's Empowerment Zone and Enterprise Community program was authorized by Congress in the Omnibus Budget Reconciliation Bill of 1993. This program was designed as a competitive demonstration program for revitalizing distressed communities pursuant to a strategic plan developed at the community level and supported by local and state governments, the federal government, and the private sector. Over 500 communities that satisfied various poverty, population, and size criteria were nominated for designation, with many communities hailing the application process itself for producing tremendous benefits. On December 21, 1994, nine Empowerment Zones and 95 Enterprise Communities were designated. Qualifying businesses in all of the designated areas became eligible for a new category of tax-exempt financing, and businesses in Empowerment Zones also became eligible for a significant federal wage credit and a capital investment incentive.

The Empowerment Zone and Enterprise Community proposal, which is an important component of the President's Community Empowerment agenda, would authorize a second round of designations, adding another 100 distressed urban and rural communities to the 104 designated in December 1994. The second round would build upon the solid successes of the first round, and would also strengthen the tax incentives available to businesses in the designated communities (including the brownfields tax incentive, additional section 179 expensing for small businesses, and new tax exempt bonds).

The Treasury Department will be submitting written testimony to the Subcommittee on these matters.

FOR IMMEDIATE RELEASE July 25, 1996

WRITTEN STATEMENT OF DONALD C. LUBICK ACTING ASSISTANT SECRETARY (TAX POLICY) DEPARTMENT OF THE TREASURY BEFORE THE ...SUBCOMMITTEE ON OVERSIGHT HOUSE COMMITTEE ON WAYS AND MEANS

Madame Chair and Members of the Subcommittee:

In its announcement of this hearing on June 21, 1996, the Subcommittee indicated that among the provisions it would consider were the tax treatment of environmental remediation costs and incentives for locating businesses in empowerment zones. I am pleased to present the Administration's views on these two topics.

The Administration is engaged in a variety of efforts to encourage cleanup and redevelopment of economically distressed sites. Earlier this year in his State of the Union Address, President Clinton called for targeted tax incentives to help accomplish these goals, and included such initiatives, fully paid for, in his Fiscal Year 1997 Budget.

The President's brownfields tax incentive is intended to spur the cleanup and redevelopment of thousands of contaminated sites, and together with the new Empowerment Zone and Enterprise Community proposal, will help to rebuild neighborhoods, create jobs, and restore hope to our nation's cities and distressed rural areas.

Congressman Rangel has introduced the President's brownfields and Empowerment Zone proposals as H.R. 3747. Senators Mosely-Braun, Jeffords, and D'Amato have introduced a companion measure in the Senate, S. 1911. The Administration strongly urges the Subcommittee to favorably consider these proposals.

Environmental Remediation Costs

Background. Under current law, costs incurred for new buildings or for permanent improvements made to increase the value of any property (including amounts incurred to prolong the useful life of property or to adapt property to a new or different use) are not currently deductible, but must be capitalized. This general capitalization requirement covers both purchases and improvements to currently owned assets, but does not apply to repairs (which are generally deductible when incurred with respect to business property as ordinary and necessary business expenses).

<u>President's Proposal</u>. The President has proposed a targeted tax incentive to clean up "brownfields" — abandoned, contaminated industrial or commercial properties that are less contaminated than Superfund sites, but still face barriers to redevelopment. Under this proposal, certain remediation costs would be currently deductible if incurred with respect to a qualified site.

This incentive is expected to cost approximately \$2 billion while leveraging \$10 billion in private cleanups nationwide and returning to productive use as many as 30,000 brownfields. It will also improve environmental and public health protection, and spur economic development. It has been designed specifically to affect land use in a positive way in distressed urban and rural areas.

<u>Details</u>. Generally, the expenses that would be deductible under the President's proposal are limited to those paid or incurred in connection with the abatement or control of environmental contaminants. For example, expenses incurred with respect to the demolition of existing buildings and their structural components would not qualify for this treatment except in the unusual circumstance where the demolition is required as part of ongoing remediation.

Qualified sites would be limited to those properties that satisfy use, geographic, and contamination requirements.

- 1. The use requirement would be satisfied if the property is held by the taxpayer incurring the eligible expenses for use in a trade or business or for the production of income, or the property is of a kind properly included in the inventory of the taxpayer.
 - 2. The geographic requirement would be satisfied if the property is located in:
 - -- any census tract (or comparable area) that has a poverty rate of 20 percent or more;
 - any other census tract (i) that has a population under 2,000, (ii) 75 percent or more of which is zoned for industrial or commercial use, and (iii) that is contiguous to one or more census tracts with a poverty rate of 20 percent or more;
 - -- an area designated as a federal Empowerment Zone or Enterprise
 Community, including the 104 designated on Dec. 21, 1994, and the
 additional 102 that would be designated under the President's proposals
 described below; or
 - -- an area subject to one of the 40 Environmental Protection Agency (EPA) Brownfields Pilots announced prior to February 1996.

These qualified sites encompass roughly 30 percent of the country. Both urban and rural sites would be eligible, though Superfund National Priority listed sites would be excluded.

3. The contamination requirement would be satisfied if hazardous substances are present or potentially present on the property. Hazardous substances would be defined generally by reference to sections 101(14) and 102 of the Comprehensive Environmental Response Compensation and Liability Act (CERCLA).

To claim this deduction, the taxpayer must obtain a statement that the site satisfies the geographic and contamination requirements from a State environmental agency designated by the EPA for such purposes. It is anticipated that in States with voluntary cleanup or similar programs, this process will be handled by the State or local agency overseeing that program. With respect to other States, it is anticipated that EPA will provide the necessary statements until appropriate State agencies are designated to take over that task.

This deduction would be subject to recapture under current-law section 1245. Thus, any gain realized on disposition generally would be treated as ordinary income, rather than capital gain, up to the amount of deductions taken. This recapture rule is limited to deductions claimed under this provision. Environmental cleanup expenses that are deductible under current law would not be subject to recapture. No inference is to be drawn from this proposal regarding the proper tax treatment of any expense under current law.

The deduction, which would apply for alternative minimum tax purposes as well as for regular tax purposes, would be effective for eligible expenses incurred after the date of enactment

Empowerment Zones and Enterprise Communities

Background. In the Omnibus Budget Reconciliation Act of 1993 (OBRA '93), Congress authorized a federal demonstration project in which nine empowerment zones (EZs) and 95 enterprise communities (ECs) would be designated in a competitive application process. State and local governments jointly nominated distressed areas and, along with community participants, proposed strategic plans to stimulate economic and social revitalization. The response of communities was dramatic, with over 500 applications submitted by the June 30, 1994, deadline. According to a large number of applicants, significant benefits were realized from going through the application process itself. On December 21, the Secretaries of Housing and Urban Development (HUD) and Agriculture designated the nine EZs (six in urban areas and three in rural areas) and 95 ECs (65 in urban areas and 30 in rural areas).

Among other benefits, certain businesses located in EZs are eligible for three federal tax incentives: an employment and training credit; an additional \$20,000 per year of section 179 expensing; and, a new category of tax-exempt private activity bonds. Certain businesses located in ECs are eligible for the new category of tax-exempt bonds. OBRA '93 also provided that federal grants would be made to designated areas.

These federal tax incentives are one component of the efforts to encourage increased economic activity and the revitalization of the distressed areas. While the tax incentives in and of themselves may have only indirect impact on land use, there are numerous non-tax elements of the designated communities' strategic plans that are likely to have a significant impact on land use, including initiatives aimed at improving educational and training opportunities, transportation, day care, housing, crime prevention, and environmental safety.

<u>President's Proposal</u>. Given the early success of these efforts and their tremendous promise, the Administration believes that the number of authorized empowerment zones should be expanded, subject to budgetary constraints. Extending tax incentives to economically distressed areas will help stimulate revitalization of these areas. Accordingly, the President's Fiscal Year 1997 Budget proposes to authorize the designation of additional Empowerment Zones and Enterprise Communities, with new tax incentives, including the brownfields initiative, additional small business expensing, and new private activity bonds.

<u>Details</u>. The President has proposed a three-part expansion of the of the federal empowerment zone proposal:

- 1. Two additional urban EZs could be designated under the OBRA '93 criteria within 180 days of enactment. Qualifying businesses in these areas would be eligible for the same tax incentives available to businesses in the EZs designated on December 21, 1994.
- 2. The OBRA '93 criteria would be modified to allow a broader range of businesses to borrow the proceeds of the tax-exempt bonds and, in empowerment zones, to qualify for the additional section 179 expensing. However, the requirements that at least 35 percent of a business's employees be zone residents, and that the tax-exempt bonds be applied against the State volume caps, would remain unaltered. These changes would be effective for bonds issued after the date of enactment and, with respect to expensing, for taxable years beginning on or after the date of enactment.
- 3. The designation of twenty additional EZs and 80 additional ECs would be authorized. Among the 20 EZs, 15 would be in urban areas and 5 would be in rural areas. The 80 ECs would be divided between 50 urban areas and 30 rural areas. The designations would be made before January 1, 1998.

The eligibility criteria for these new zones and communities would be expanded slightly. First, the poverty criteria would be relaxed somewhat, so that unlike the first round, there would be no requirement that at least 50 percent of the population census tracts have a poverty rate of 35 percent or more. In addition, the poverty criteria will not be

applicable to areas specified in the application as developable for commercial or industrial purposes (1,000 acres in the case of an enterprise community, 2,000 acres in the case of an empowerment zone), and these areas will not be taken into account in applying the square-mileage size limitations (20 square miles for urban areas, 1,000 square miles for rural areas).

Nominations of rural census tracts (or comparable areas) that exceed 1,000 square miles in size or that include a substantial amount of governmentally owned land may exclude such excess mileage or governmentally owned land. Unlike the first round, Indian reservations will be eligible to be nominated (and the nomination may be submitted by the reservation governing body without the State government's participation). The Secretary of Agriculture will be authorized to designate up to one rural empowerment zone and five rural enterprise communities based on specified emigration criteria without regard to the minimum poverty rates set forth in the statute.

The second-round EZs would have available a different combination of tax incentives than those available to first-round EZs. The additional section 179 expensing, as modified above, and the proposal to provide tax incentives for remediation of "brownfields" to zones and communities (described above) would be available in the second-round EZs. Enterprise zone businesses in the second-round EZs would also be eligible for a new category of tax-exempt financing. These bonds, rather than being subject to the current State volume caps, will be subject to zone-specific caps. For each rural empowerment zone, up to \$60 million in such bonds may be issued. For an urban empowerment zone with a population under 100,000, up to \$130 million of these bonds may be issued. For each urban empowerment zone with a population of 100,000 or more, up to \$230 million of these bonds may be issued. The empowerment zone employment credit will not be available to businesses in the new empowerment zones, and the increased expensing under section 179 will not be available in the developable acreage areas of the second-round empowerment zones.

The additional ECs would have available the same tax incentives that apply to the existing communities (including the private-activity bond modifications and "brownfields" tax incentives included in these proposals).

STATEMENT OF BARTOW S. SHAW, JR.
FOR THE
AMERICAN FOREST & PAPER ASSOCIATION
AND THE
FOREST INDUSTRIES COUNCIL ON TAXATION
ON THE IMPACT OF TAX LAW ON LAND USE
SUBMITTED TO THE
SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES
JULY 16, 1996

My name is Bartow Shaw. I am Chairman of the firm of Shaw, McLeod, Belser & Hurlbutt, Inc. of Sumter, South Carolina. We are a forestry consulting firm managing timberland primarily for non-industrial landowners. I am, also, a timberland owner myself. I am a member of the Board of Directors of the Forest Industries Council on Taxation, the national trade association which represents the forestry industries and non-industrial landowners on all federal forestry tax issues. In addition, I have served on the Board of Directors of the American Forest & Paper Association, the national trade association of the forest products and paper industry. AF&PA represents a vital national industry which accounts for over 7 percent of the total U.S. manufacturing output and employs some 1.6 million people. I wish to thank you for providing me the opportunity to submit to the Subcommittee this statement about the impact of tax law on land use, an issue that is vitally important to tree growers and landowners throughout the nation.

Forest owners are located in nearly every region of the nation. They own 350 million acres of woodlands, encompassing more than 72 percent of all commercial forests. The typical non-industrial landowner is not a wealthy individual, owning an average of less than 50 acres of woodland and with an average household income of less than \$50,000 per year. Our firm has served hundreds of non-industrial clients for almost three decades, and I can relate from experience that a great many of them now face a return much lower than expected when they invested in reforestation because of the Tax Reform Act of 1986 and its treatment of capital gains.

Since its enactment in 1944, capital gains treatment for timber dispositions has resulted in impressive gains in planting and productivity. However, tree planting has suffered a continual declining trend since 1986. I feel the increase in capital gains rates has been a major factor in causing this decline.

A more limited timber supply will lead to significantly greater pressure to increase timber removals from public lands at a time when those harvests are being reduced for a variety of reasons. I believe we are just now beginning to see the effects of a shift in timber harvest from the Pacific Northwest lands to the Southeast. Because of the time required to effectively create sustainable forests to meet the demands of the market, we need to urgently put the tax policy in

place <u>now</u> before demand for product puts our resource in a position where it is impossible to catch up. Unfortunately, I feel more comfortable about the future value of the timber and the demand for products derived from that resource than I do about a consistent tax policy that will last the lifetime of the investment. Tree farmers who planted trees 25 years ago have seen the treatment of capital gains change several times. Many of them now ask, why invest in something so risky and for such a long period of time if taxes will eat away most of the profit? In my opinion, the federal government should develop a relatively stable tax policy to favor sustainable management of nonfederal forests.

The Balanced Budget Act of 1995 contained provisions drafted by Chairman Archer which would have cut the tax rate on capital gains for both individuals and corporations. This provision would have encouraged long-term investments and risk taking, which timber growing certainly is. Any improvement in the climate for long-term investments, we feel, would be a step in the right direction.

The second area of tax law that is having a devastating effect on land use in our industry is the current federal estate tax. As I mentioned earlier, timber growing is a long-term illiquid endeavor with many, many risks. Many family owned tree farms and small businesses are being destroyed by the federal estate tax. Inflation in land values has pushed otherwise modest businesses and tree farms into the top estate tax brackets. Although the average individual tree farmer earns a modest income, on paper his tree farm can be valued at well over \$2 million, including the value of mature and harvestable timber. In many cases, when the heirs are presented the estate tax bill, they are forced to harvest their timber prematurely, sell a portion of the farm, or liquidate the entire property. Many of these productive tree farms located near large metropolitan areas are now subdivisions or shopping areas. That certainly is a change in land use, perhaps not for the better.

In closing, I would like to thank the members of this Subcommittee and the full Ways and Means Committee for having this hearing on tax law's impact on land use. It represents a commitment to a federal tax policy that will provide future generations the multiple benefits from America's privately-owned forests.

Statement of the

American Institute of Architects

The American Institute of Architects (AIA) is the professional society representing this nation's architects. On behalf of its members, the Institute submits the following comments on land use and tax reform to the U.S. House Ways and Means Subcommittee on Oversight.

It is an architect's challenge to envision the "big picture" and to attain it by piecing together many components in a manner that maximizes form, function, and value. Architecture is a balance of poetics and pragmatics.

As our country has grown, the issue of wise land use and development has become increasingly difficult to address. Now, more then ever, when fiscal resources are scarce and open spaces are dwindling, it is imperative that the nation and our localities make decisions about the development of neighborhoods, commercial areas, schools, recreation facilities, and infrastructure. Urban sprawl has become the norm, and low-density development has overtaken the landscape, imposing enormous and inefficient dollar and resource costs for water, sewer, and power infrastructure.

One way to slow urban sprawl and control the mass exodus from this nation's cities is to provide incentives for businesses to remain in urban areas. Businesses serve as community anchors, offering employment opportunities, generating tax revenue and local spending, providing services, and attracting residents and more businesses in turn.

The Commercial Revitalization Tax Credit (CRTC), H.R. 2138/S. 743, introduced by U.S. Congressman Phil English in the House and U.S. Senator Kay Bailey Hutchison in the Senate, would provide such an incentive to businesses, encouraging investment in economically distressed areas. Similar credits already in effect for related purposes such as housing and historic preservation bear this out.

We urge the Members of this Subcommittee to join the 44 House cosponsors of H.R. 2138 in endorsing this bill.

The legislation permits a choice between two available tax credits that may be carried forward or backward against tax obligations. The first choice is a credit equal to 20 percent of eligible construction and related expenses. The entire credit may be used in a single tax year.

The second option allows a taxpayer to apply five percent of eligible expenses to the annual tax liabilities over a ten year period. The legislation encourages significant investment, so routine maintenance would not be an eligible expense, nor any expenditure less than 25 percent of the tax basis of the building or project. Creditable expenses would have a lifetime limit of \$10 million per project. Total available credits would be \$1.5 billion over five years following enactment.

It would be paid for in three ways-claiming a small slice of tax reductions that Congress has decided to enact; generating economic activity that returns money into the Treasury; and shifting resources from untargeted programs such as the 10 percent rehabilitation tax credit.

Monies would be allocated directly to the states according to a formula, based on population. The states would have the freedom to establish their own programs, although the legislation anticipates that projects awarded credits would be chosen based on their fulfillment of strategic plans developed under a public participation process, and their potential to create permanent jobs.

Businesses eligible for the commercial tax credit could be located in existing federal Empowerment Communities/Enterprise Zones (EC/EZs), state EC/EZ's or their equivalent, or any revitalization area established by federal, state, or local law that contains a population of which at least 50 percent earn less than 60 percent of the median area income. About 500 communities that applied for EC/EZ designation from the federal government were not selected. Most of these places have quality revitalization programs ready to implement, given sufficient incentives to attract private capital.

The AIA believes CRTC is well-targeted, built on proven and accepted mechanisms for delivering tax incentives. The proposal is designed to reward success: eligible projects must be included in a locally developed strategy for revitalization and long-term sustainability, and the credit may not be taken unless the business is generating taxable revenue and the commercial structure is actually placed in service. It would operate with a minimum of bureaucracy, complement other incentives, leverage existing infrastructure, and put buildings that are economic and social liabilities back into productive use.

If one examines similar credits, it is clear that the proposed CRTC has significant potential for encouraging investment in places businesses left years ago. The Low-Income Housing Tax Credit Program (LIHTC) provides \$320 million in credits per year, which generates \$2.8 billion a year in wages and salaries and \$1.3 billion in tax revenues. It also creates about 110,000 jobs in construction and related industries.

Another related tax credit is the historic rehabilitation tax credit, which may be applied to historic properties on the National Register of Historic Places. This credit provided \$97 million in FY 1994, generated \$483 million in private investment, and created 21,000 jobs. Both of these credits contribute significantly to the betterment of communities and neighborhoods.

An effective capital-based incentive for non-historic commercial projects in targeted areas is a missing piece of the incentive package that must be made available to reduce the risk of investment. The CRTC is not a panacea. It cannot in and of itself solve the problems of economically distressed communities and urban sprawl. It can, however, tip the balance for a business considering expansion or new development in existing neighborhoods.

The AIA believes the CRTC represents a feasible, common sense solution to the inefficient use and inappropriate placement of this nation's resources. We commend the Chairwoman for addressing this issue and exploring alternative options sooner rather than later, and the AIA stands ready to work with the Subcommittee in the future. Thank you.

Written Statement of

AMERICAN VINTNERS ASSOCIATION

by Simon Siegl President

Submitted for the

SUBCOMMITTEE ON OVERSIGHT

of the COMMITTEE ON WAYS AND MEANS U.S. HOUSE OF REPRESENTATIVES

HEARING ON THE IMPACT OF TAX LAW ON LAND USE

July 25, 1996

Introduction

Chairwoman Johnson and Members of the Subcommittee, thank you for allowing the American Vintners Association ("AVA") to submit testimony relating to the impact of tax law on land use. The AVA is a national trade organization of American vintners with a membership of over 500 wineries in 42 states. We appreciate the opportunity to discuss one of the major land use issues currently faced by farmers, vintners, and other crop owners. The problem we would like to address relates to the financial burden that farmers face when their crops are damaged by disease or natural disaster.

As described below, the devastating impact of phylloxera and frostkill on the wine producing industry is a prime example of the harmful effects that natural disasters can have on land use, both economically and environmentally. Crop owners attempting to recover from such losses often face insurmountable costs, resulting in long periods of inactivity for the farm or vineyard. Such nonuse significantly weakens the economic stability of the industry, and can also damage the land itself, especially when the land is converted to less beneficial uses during the period of inactivity.

In 1986, Congress recognized the severity of this burden and enacted section 263A(d) (2) of the federal tax code, which allows farmers to deduct certain casualty expenses. Unfortunately, the IRS has adopted an excessively narrow interpretation of this statute, preventing crop owners from claiming the tax benefits that section 263A(d) (2) was intended to provide. Because of the restrictive reading imposed by the IRS, many farmers are unable to recover from the severe losses caused by natural disasters.

Congressman Bill Thomas (R-CA) has introduced a bill, H.R. 3749, that would clarify the appropriate interpretation of the 1986 farm casualty rule for deducting the costs of replanting destroyed crops. The American Vintners Association urges the Committee to adopt this important legislation.

Impact of Natural Disasters on Crop Owners and Land Use

Natural disasters can have a catastrophic effect on farmers whose crops do not reach marketable production until many years after planting. When diseases or other severe conditions destroy a farm or vineyard, crop owners must invest large amounts of money to restore their businesses to working condition. Banks and other financial institutions are reluctant to take the risks involved with replanting, particularly when weather and other natural disasters may destroy the crops again. Furthermore, even when the damaged property is replaced, it may take another three

to four years before a commercially harvestable crop can be obtained, thereby eliminating any revenue from the farm or vineyard for an extended period of time. Finally, periods of nonuse due to economic hardship can cause environmental damage to the land itself.

While wine producers and grape growers are not the only ones impacted by such losses, their situation provides a good illustration of how such natural disasters negatively impact both crop owners and their lands. Wine producers and grape growers across the country have been faced with severe damage caused by pests and extreme weather conditions. In the wine growing regions of New York, Pennsylvania, Ohio, Michigan, Missouri, and Arkansas, low temperatures lead to "frostkill" -- a weakening of the vines which kills crops or leaves them vulnerable to disease and infestation. The affected vines must be removed and replaced in order for grape production to continue.

Crop owners in California and Oregon, similarly, have been faced with severe damage caused by a pest known as phylloxera. Phylloxera is a small aphid-like louse which, because it is impervious to pesticides, can be eliminated only be removal of the infested vineyards (including irrigation equipment, drain tiles, and trellis systems) and the subsequent fumigation and replanting of vineyards with root stocks resistant to the pest. Furthermore, the Department of Agriculture has stated that the failure of a grape grower to eliminate the phylloxera from one vineyard could have devastating consequences for vast areas of vineyards.

Wine producers faced with a natural disaster such as phylloxera or frostkill must generally replace entire vineyards in order to salvage their business. However, vines and root stock cannot be removed without removing related improvements, since the irrigation equipment, trellis systems, and drain tiles are inextricably linked with the mature vines and root systems. Furthermore, once a vineyard is removed and replaced, it still takes many additional years for the vineyard to reach its precasualty maturity level and revenue generation capability.

The huge costs required to replant devastated vineyards have forced many farmers to keep their land lying fallow or used for less environmentally beneficial purposes. Vineyards are a uniquely benign form of land use, because they require very minimal amounts of water compared to other crops and because they employ integrated pest management and other "sustainable agriculture" practices. Therefore, when nonproductive vineyards are converted to alternative land uses, environmental harm -- in addition to economic damage -- inevitably results.

Congressional Intent and the Farm Casualty Rule

Section 263A of the tax code, enacted as part of the Tax Reform Act of 1986, generally requires a taxpayer engaged in a farming business to capitalize all costs that are incurred in manufacturing or constructing tangible personal property. However, recognizing the burden faced by crop owners dealing with natural disasters, section 263A(d)(2) provides an exception for costs that are incurred by a taxpayer whose crops are destroyed by certain casualties. Specifically, section 263A(d)(2) allows a taxpayer to deduct "any costs" incurred for "replanting plants bearing the same type of crop" after a crop has been damaged "by reason of freezing temperatures, disease, drought, pests, or casualty."

The plain meaning of this statute indicates that Congress intended the farm casualty rule to alleviate the tax burden that farmers face when their crops are destroyed by disease or natural disaster. Despite this statutory language, however, the IRS has adopted an unduly narrow interpretation of section 263A(d)(2).

Under the IRS reading of the law, a grape grower whose vineyard has been destroyed by disease or natural disaster may <u>not</u> deduct the costs of vines, vinestock, soil fumigation, trellises, irrigation equipment, or drainage systems. The IRS reading of the law limits casualty deductibility to preproductive period expenses, forcing most costs to be capitalized.

The Solution: Amend the Code to Allow Deductibility

H.R. 3749, the measure introduced by Rep. Thomas, would amend section 263A(d) (2) to help ensure that farmers are able to finance their replanting costs, thereby curbing the negative impact on land use that such natural disasters can have. The bill would allow taxpayers to deduct certain expenditures, incurred after December 31, 1995, for replanting destroyed crops.

A number of special rules are included in this bill to ensure that abuses do not occur. The bill allows continued deductibility of all preproductive period costs. However, in recognition that some improvements might be made during the replanting process, certain costs, referred to as "special replanting costs," would only be 80 percent deductible. Such costs would include tangible assets such as plants and their supporting structures, and irrigation and drainage systems where such systems were destroyed during removal of the damaged plants. The bill includes a clear definition of "preproductive costs," and includes language to prevent taxpayers from receiving a double benefit by taking loss deductions on the same expenditures which are subject to this rule.

We believe that enactment of this legislation is the only feasible way to ease the insurmountable burden faced by many crop owners, and to ensure that the farm casualty rule is interpreted appropriately. On behalf of the American Vintners Association and the entire wine industry, we thank the Subcommittee for the opportunity to testify on H.R. 3749 and its impact on land use. Please do not hesitate to contact us if we can provide you with any additional information on this important issue.

Submission to
The Committee on Ways and Means
Subcommittee on Oversight
Hearing on
Impact of Tax Law on Land Use
By Thomas Bier

My name is Thomas Bier. I am director of the Housing Policy Research Program at Cleveland State University, Cleveland, Ohio, a position I have held for 14 years. Since I am unable to attend the hearing on July 16, 1996, I wish to submit the following statement.

Research I have done indicates that Section 1034 of the IRS Code promotes movement of homesellers out and away from central cities and obstructs movement inward. The effect of that is to promote the outward sprawl of metropolitan areas, and to undermine the fiscal strength of central cities

Sec. 1034 concerns capital gain realized through home-ownership. If a home increases in value the gain is taxable at the time of sale — unless the seller purchases another home of equal or greater value. In that case tax liability is postponed (or rolled over).

The postponement can extend through any number of moves as long as the price of each home that is purchased at least equals the price of the home sold.

At age 55 the homeowner qualifies for a one-time tax exemption. The owner can then sell, not purchase ancther home of equal or greater value and not have to pay tax on up to \$125,000 of capital gain over and above the purchase price of the first home. (That provision provides needed capital for many retirees.)

The origin of Sec. 1034 was the Revenue Act of 1951. During the Cold War build-up, industry employers were finding that their need to move employees around the country was being impeded by the taxation of homeseller capital gain. At that time no one could have anticipated that the new capital gain provision, meant to free movement between cities, would eventually restrict movement within cities, or metropolitan areas.

The requirement that a seller purchase a home at least equal in price to the one sold in order to avoid being taxed is a major incentive not to move down in price. If a city's home prices happen to be lower than prices in surrounding suburbs (and usually they are), the law is a serious obstacle to moving into the city -- irrespective of other possible obstacles such as concern over crime or quality of schools.

The problem is not just the city's. The law discourages sellers at all price levels, city and suburban, from moving down in price, thereby restricting the housing choices available to them, and it encourages them to move up in price. Typically moving up means moving further out.

The more that the geographic pattern of home values across a metropolitan area is one of increasing value with distance from the center, the more that city and suburban sellers will move outward. The more they do that, the more that sprawling outer suburban development will occur, and the more that city (and eventually inner suburban) decline will result.

Our study (report enclosed) of the geographic pattern of home values and the movement of sellers in the Ohio metro areas of Akron, Cincinnati, Columbus, Cleveland, Dayton, Toledo and Youngstown confirmed the expected patterns.

- > 90 percent of the city sellers, and 75 percent of the suburban sellers, moved further out to buy their next home.
- > 80 percent of all sellers met the capital gain provision (bought a home priced at least equal to the one sold), 84 percent of whom moved further out and 16 percent moved closer to the city center.

Of the 20 percent who did not met the provision, 64 percent moved further out while 36 percent moved closer in.

Those who did not comply moved inward at a rate 2.3 times greater than those who did comply (36 percent vs. 16 percent), which suggests the possibility that more would move inward were it not for the capital gain provision.

Not only does Sec. 1034 foster urban sprawl and central city decline by obstructing movement down in price, it also disadvantages homeowners who are forced to move down because of personal circumstances such as illness or employment change to a lower level of income. The code penalizes those least able to absorb it.

For those reasons Sec. 1034 should be revised to remove the penalty against moving down in price; allow movers to go freely up or down until aged 55 (or older) after which they can settle up with IRS on their net gain, using the \$125,000 exemption.

Better still would be to remove the tax on homeseller capital gain all together. It would cost the treasury something (I've heard an estimate of about \$3 billion) but most gain now is little more than inflation. Most homeowners may be lucky to stay even with inflation.

Thomas Bier, Director Housing Policy Research Program Levin College of Urban Affairs Cleveland State University Cleveland, Ohio 44115 (216) 687-2211 FAX 687-9277



Statements of the California Farm Bureau Federation

To
The House Ways and Means
Subcommittee on Oversight
The Honorable Nancy L. Johnson, Chair

Regarding

IMPACT OF TAX LAW ON LAND USE

July 16, 1996

The California Farm Bureau Federation (CFBF) is the largest general farm organization in the state. We have more than 42,000 member farm families and more than 72,000 member families in total. Nationwide our views are reflected by the American Farm Bureau Federation, which represents more than four million members. We appreciate the opportunity to provide a statement in support of changes that are needed in the tax code to ensure that the business of family farming may continue for generations to come. This subcommittee and Congress have an excellent window of opportunity to address the implications of federal tax policy on land use in a very constructive and meaningful way.

FEDERAL ESTATE TAXES

Often under current tax laws a farm must be sold in part or total to satisfy estate taxes. Many of these farms are multi-generation family businesses. The agriculture industry is dependent on the ability to pass the family farm down from generation to generation. Without changes in the estate tax law, it will be difficult to maintain family farming as we know today. Federal estate tax law has the ability to close family farm operations and shift agriculture land into other uses.

Last updated in 1987, the per person exemption for assets under federal estate tax law is \$600,000 for the value of an estate. CFBF has long called for the elimination of the estate tax, or at least, an increase in the exemption to \$2 million along with future indexing. Years of inflation have outdated existing estate tax laws. Estate tax relief would encourage new investment, increased savings, and the removal of disincentives to pass on family farming and small business operations.

CFBF policy supports an increase in the ceiling allowed in determining the existing exemption under Internal Revenue Service Code 2032-A for agriculture productive value. This provision allows for land to be valued for estate tax purposes at its agricultural value rather than its market value. Due to the nature of California land values, the current limitation of \$750,000 is not adequate. Removing the limit would reduce the potential for land to change uses to meet the cost of estate taxes.

CAPITAL GAINS TAXES

Many farmers and ranchers nearing retirement are interested in selling land to younger farmers and ranchers, including family members, but are inhibited by current capital gains tax law. Farmers pay capital gains taxes when they sell their land. Farmers typically hold their land for long periods of time. The national average is 28.6 years and over this period the value of total farms real estate in the U.S. has increased 4.27 times. The increase has been due to nothing more than inflationary gains. For tax purposes, the gain from the sale or exchange of an asset held more than one year is characterized as a long-term capital gain. For individuals, current law taxes capital gains as ordinary income at 28 percent. The current capital gains tax treatment results in an inordinately high level of farm lands held by absentee land owners -- widows and retirees.

In California, many farm commodities such as timber, Christmas trees, breeding livestock, dairy cows, and equine have extended production cycles making them subject to capital gains treatment. The capital gains tax creates a disincentive for farmers to upgrade farm operations because taxes must be paid on farm assets sold to finance improvements. Unimproved farm businesses are less efficient and less profitable.

The United States has among the highest capital gains tax rates in the world. We support elimination of the capital gains tax, or at the very least, a maximum tax rate of 15 percent, indexed for inflation. This much needed reform would facilitate land transfers and the movement of capital assets to beginning farmers and ranchers. Capital gains tax relief would allow many older farmers and ranchers who are delaying selling their assets because of the tax, which results in the reduction of land available to new producers, to do so.

The capital gains tax is a direct obstacle to better land management because it discourages infill development and redevelopment of abandoned or under-utilized property in urban areas. Capital gains relief would provide an incentive to landowners to either sell, develop, or improve urban property so that it can be used more intensively.

A major hurdle to greater utilization of existing urban infrastructures and more efficient use of land is the tax disincentive to sell or improve real estate holdings. Owners of real property with low capital gains basis have little desire to sell their land. By providing a substantial shelter for capital gains income derived from the sale of qualified property, infill and redevelopment could be enhanced.

FARMERS AND RANCHERS INDIVIDUAL RETIREMENT ACCOUNTS

CFBF supports farmers and ranchers ability to achieve retirement security without having to sell their land for development. In order to achieve security, fully deductible Individual Retirement Accounts (IRA) for qualified farmers and ranchers, up to a set percentage of their Schedule F income should be provided. In agriculture especially land holding typically represents most of the owners life savings and when they do sell, they pay taxes on their investment as a lump sum at a much higher rate than people who can withdraw their retirement savings over time.

One of the primary obstacles to long-term agricultural land conservation is the need from elderly farmers and ranchers to base their retirement on the cash equity in their land. Under this proposal, filers of Schedule F who derive at least 75 percent of their income from farming and ranching would qualify to fully deduct their IRA investments up to 10 percent of their net farming income.

We will continue to work for a reduction in both estate and capital gains taxes, the establishment of Individual Retirement Accounts for farmers, and the protection of agriculture lands.

Once again, thank you for the opportunity to submit a statement to the subcommittee. We welcome any assistance that you may provide in supporting the continuation of family farmers and ranchers ability to pass the business down from generation to generation.

STEVEN B. CORD, President

ALBERT S. HARTHEIMER, Vice President

FRED KARN, JR., Treasurer

JOSHUA VINCENT, Secretary

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STATEMENT BY DR. STEVEN CORD FOR C.S.E. ON THE

IMPACT OF FEDERAL TAX LAW ON LAND USE

BEFORE THE H.R. COMMITTEE ON WAYS & MEANS, 7/11/96

The federal government should encourage state & local governments to shift as many of their taxes as possible to the assessed value of land, for these reasons:

- (1) State & local governments penalize building ownership, retail sales and income when they tax such desirable things. Such taxes hurt the economy and cause the federal government to levy high income taxes to fund government programs.
- (2) Governments should get their revenue by taxing land assessments instead. Such a tax encourages land owners to develop their sites in order to obtain an income from the improvement which can pay the higher land value tax as well as for the improvement also, thereby creating jobs and economic growth). Here is a revenue source that actually promotes economic growth at no extra tax cost to the taxpayer ("no extra tax cost" because only a tax shift from buildings to land is involved). By promoting tax-free urban rejuvenation, we will be containing urban sprawl into the clean-and-green countryside.

In the 21st century, the payment of the general budget debt and Social Security benefits will absolutely require such a tax (since it promotes land development), but these are ways by which the federal government can encourage state & local governments to levy such a tax now:

- o H.U.D. and D.O.T. can condition state & local grants on adoption of a land value tax (but this must be done gradually).
- o H.U.D. can require enterprise zones and a new city to levy a land value tax.
- o H.U.D. can promote the benefits of land value taxation to states and cities.
- o The federal government can levy an income tax on annual land rent; we can advise on this, having received much experience by working with all 17 land-value-taxing cities and a school district in the U.S. And there are other ways by which the federal government can promote better land use through land value taxation.

We have performed many studies substantiating all the claims made above. About 700 cities throughout the world use land value taxation, and all studies indicate it works well. Many well-known authorities have endorsed this proposal, including seven recent American Nobel Prize winners in economics.

Now is the time for our federal government to promote better land use.

#4330

Clement Dinsmore

3726 Veazey Street, NW Washington, DC 20016-2229

July 26, 1996

Honorable Bill Archer Chairman Honorable Sam Gibbons Ranking Member House Committee on Ways and Means 1102 Longworth House Office Bldg. Washington, D.C. 20515

Dear Mr. Chairman and Congressman Gibbons:

We want to express appreciation for the hearings your Committee conducted on Tuesday, July 16 through the Oversight Subcommittee on the impact of Federal tax law on land use.

The Location-Efficient Mortgage Partnership: Using Non-Tax Incentives To Encourage Efficient Communities

We--the Surface Transportation Policy Project, the Natural Resources Defense Council, and the Chicago-based Center for Neighborhood Technology--are partners in implementing a new approach to single family residential mortgage lending called the Location-Efficient Mortgage program. Attached are materials that describe our purposes and the general status of our efforts.

We believe that the inefficient use of land resources in this country results in the inefficient use of public and private capital and human resources and aggravates the social welfare and health costs that our society is struggling to finance.

We believe that more efficient use of land has many economic, social, environmental, and other benefits. We are embarked upon a long term effort to encourage location efficiency—the efficient location of residential, transportation, employment, commercial, institutional [such as health care, education, and job training], and public land uses relative to each other. We have created a Foundation for Location Efficiency to organize this effort.

In the shorter term we are seeking the cooperative participation of mortgage lenders and secondary mortgage market institutions in the demonstration of the Location-Efficient Mortgage program. We believe that through this program we can create <u>non-tax</u> financial incentives for American households to choose to live in "location-efficient" communities—communities with higher densities that support public transportation services and encourage the efficient proximity of places of employment, employment training, residence, health care, shopping, education, recreation, and other daily household activity.

The Federal Tax Code and Resource Use Incentives

Various provisions of the Federal tax code create incentives and disincentives that have encouraged or attempted to compensate for the historic, inefficient use of our land and other resources. These are not limited in their applicability to the activities of any one economic sector, such as housing construction and finance. They are myriad in their application to different parties.

Federal Budgetary and Revenue Gains Through Location Efficiency

Location efficiency encourages a more efficient utilization of the capital investment that already has been made in urban utilities and infrastructure necessary to household and business activities. A more efficient realization of the benefits of existing investment in turn reduces the demand for capital to finance the creation of new infrastructure, where communities do not now exist. The Federal Government would realize a major reduction in its expenditures through a decline in interest rates associated with a reduced capital demand for new urban infrastructure and utilities.

Hospitals and medical care facilities are among the urban service infrastructure that is not efficiently utilized, when development occurs inefficiently. Location efficiency would reduce the demand to create new medical care facilities in greenfields locations.

Location efficiency facilitates transportation efficiency—both for households and commercial entities. Location efficiency, therefore, helps reduce regulated air emissions and improves public health. An improvement in public health would reduce the demand for tax revenues for public health protection and medical care.

Location efficiency contemplates greater proximity of household residences to places of employment. This encourages greater accessibility of all persons, including lower income households, to job opportunities and reduces costs to employers of employee turnover, absenteeism, and late reporting for work. An increased participation of lower income households in the work force would reduce the demand for Federal and State welfare support expenditures.

An increase in location efficiency in this country would reduce the tax cost of proposals before your Committee to protect undeveloped "greenfields" and to remediate contaminated "Brownfields." Continued inefficient use of land will limit market demand for Brownfields and maintain market demand for the conversion of greenfields to urban uses. The tax cost of proposals to protect greenfields and remediate Brownfields will be greater, if market demand for greenfields does not decline and demand for Brownfields does not increase. On the other hand, increased efficiency in land use would help relieve market demand for greenfields and improve demand for Brownfields and thereby reduce the tax cost of greenfields protection proposals and Brownfields remediation proposals.

An increase in location efficiency, also, would enhance the ability of more American households to increase their financial wealth and gain access to private sector financial resources. The location-efficient mortgage program is premised upon the ability of households in location-efficient communities to reallocate their disposable income from transportation to housing expenditures. The program is designed to facilitate household access to mortgage credit and acquisition of an equity interest in residential real estate. As real estate values improve over time, that equity enables households to increase their wealth and gain access to greater credit for other purposes, such as education. Improvement in the financial well-being of American households in turn would reduce the demand for Federal tax revenues to finance household expenditures--health, education, retirement, or other.

Many of the financial incentives in the Federal tax code attempt to compensate for private markets' inattention or inadequate financing of the costs of publicly desired goods and services. If we were able to create new, non-tax incentives for creating communities with greater location efficiency, we would hope that, as these incentives gained market acceptance and enhanced the feasibility of delivering housing to more households at less cost, we could begin to reduce certain tax incentives that support financing shelter costs that are inflated by the inefficient use of land and building materials. Tax revenues would increase, as the tax subsidy was reduced.

Conclusion

We encourage your Committee's continued review of the Federal tax code for provisions that discourage the efficient organization of the economic, physical, and human environments of American communities. We will be happy to contribute to the Committee's analysis and suggest tax code modifications.

Through non-tax financial incentives we mean to reward American households that choose to live in communities that enable them to conduct their daily lives in an efficient manner. We encourage the Committee to consider how non-tax incentives may be substituted for tax incentives to achieve policy objectives.

The inefficiency of the physical environment that we have created in this country imposes economic, social, personal, and environmental costs upon our citizens. Many of these costs now are apparent. Our citizens' economic opportunities are limited, their tax burden is aggravated, and their physical and emotional health is impaired by the inefficient use of our natural, human, and financial resources.

Sincerely,

Clement Dinsmore on behalf of The Location-Efficient Mortgage Partnership

Enclosures

cc: Honorable Nancy Johnson Honorable Robert Matsui

THE LOCATION EFFICIENT MORTGAGE PARTNERSHIP

THE PARTNERS: The Location Efficient Mortgage Partnership includes the Surface Transportation Policy Project, the Center for Neighborhood Technology [Chicago], and the Natural Resources Defense Council. The Federal Transit Administration and Environmental Protection Agency are funding the Partnership's single family loan program research and development.

WHAT AND WHERE: The Partnership--using data for the Los Angeles, San Francisco, and Chicago metropolitan areas--is finetuning an analytical model developed by John Holtzclaw, consultant to the Partnership, that correlates household geographical location with relative transportation efficiency and household transportation expenditures relative to other locations within the metropolitan areas.

The Partnership--focused initially upon Los Angeles, San Francisco, and Chicago--is actively exploring with single family residential mortgage lenders and secondary market entities the utility of the analytical model in identifying affordable housing loan market opportunities for lenders in "transportation [or location] efficient areas"--areas that by reason of their greater dwelling unit density or access to public transportation require less household expenditure upon private automobile transportation. Households in these areas can use their transportation savings to finance the purchase of affordable housing.

WHEN AND HOW: The Partnership's goal of demonstrations of the utility of its model in support of the "location efficient mortgage" is included in the National Homeownership Strategy adopted a year ago by the National Partners in Homeownership and is endorsed by the President's Council on Sustainable Development in its first report.

The Partnership will be demonstrating the applications of its model at the first anniversary conference of the National Partners in Homeownership June 6 and 7 in Washington, D.C..

At and following the June conference the Partnership will be seeking to confirm interest of primary and secondary mortgage market lenders in demonstrating the "location efficient mortgage."

market lenders in demonstrating the "location efficient mortgage."

The Partnership will focus its marketing attention upon innovative, private mortgage lenders and the principal secondary market institutions, Fannie Mae, Freddie Mac, and the Federal Home Loan Bank System, as well as State and local residential funding sources, such as State and local housing finance agencies and pension funds.

WHO BENEFITS: The Partnership intends to create explicit financial rewards for households that choose to reduce their daily transportation requirements and thereby enhance their ability to dedicate disposable income to housing rather than transportation expenditures. Creation of such rewards also will benefit employers concerned with the costs to them and their employees of inefficient accessibility of employees to employment locations.

THE LOCATION EFFICIENT MORTGAGE (LEM)

How can a mortgage affect the way our cities grow? Can the same mortgage also influence transportation policy?

The Natural Resources Defense Council (NRDC), the Center for Neighborhood Technology (CNT), and the Surface Transportation Policy Project (STPP) have joined together to demonstrate that a mortgage can indeed influence both urban growth and transportation policy, while also providing a response to the need for expanded homeownership opportunities for low-to moderate-income people. As a result, the Partnership developed the Location Efficient Mortgage (LEM), an innovative solution to encourage and facilitate homeownership in transit-accessible inner city and denser suburban areas.

The LEM is based on a 1994 NRDC study by John Holtzclaw that identifies a relationship between residential density of a neighborhood and total vehicle miles traveled per household within that neighborhood. For every 100% increase in residential density, the study shows that there is a 25% decrease in vehicle miles traveled (VMT). As areas increase in density and transit service, they become more "location efficient", since they offer easy access to stores, public transit, churches, jobs, restaurants, recreation, and other common destinations. Because of this accessibility, people drive less and own fewer or no cars. Basically, the LEM makes use of the savings derived from driving less to help people afford to buy homes in location efficient areas, such as high-density inner city neighborhoods.

HOW THE LEM WORKS: The LEM partners have developed a statistical model (based on VMT vs. residential density, transit access, and proximity to stores, jobs, etc.) that shows the dollar savings per household in a location-efficient area compared to an average household in a low-density suburb. This savings is then treated as available disposable income by adding it to the maximum monthly payment allowed by the mortgage formula banks use (new formula: PHTI + Other long term debt - LEM savings <= 36%), thus enabling someone to afford a higher-priced "location-efficient" home. With the LEM, homebuyers need not be forced into distant low-density areas, where they must have a car (often one per capita). The LEM levels the playing field, allowing people who want to live in location efficient areas a simple way to afford homes normally considered out of their reach.

For example, the study shows that a typical household in the dense North Beach area of central San Francisco drives approximately 23,000 miles LESS per year than a household in Morgan Hill, a representative low-density suburb. That translates into over \$400/month in lower transportation expenses for the North Beach area. Banks currently treat both areas equally, while the LEM takes this very real savings into account. (Applied to a mortgage formula, \$400/month in transportation savings can equal approximately \$50,000 more in borrowing power.)

The LEM model builds on Fannie Mae's Desktop Home Counselor, enabling mortgage lenders to calculate and apply the savings from location efficiency easily and inexpensively. This model provides a lender with the applicant's borrowing power after asking them only a few questions, including car ownership and location of the new home. A version of this model was demonstrated at the National Partners in Homeownership Summit in Washington, D.C. in June.

HOW THE LEM CAN MAKE A DIFFERENCE: The LEM Partnership will be working with lending institutions and secondary mortgage purchasers to make location efficiency a standard part of the mortgage lending process. For lenders, the LEM offers them an

opportunity to help increase low- to moderate-income participation in the housing market. There is also the added benefit of offering an incentive to the often-neglected middle-income purchaser who might now choose to stay within the inner city. In fact, the LEM is a powerful tool for attracting these middle-income families who often decide to locate elsewhere, but could play a critical role in the economic well-being of a community as a whole.

By encouraging expanded credit access within location-efficient communities (urban or suburban), the LEM will help bring these areas a more vital housing market, and, hopefully, increased ownership opportunities, including new investment in community revitalization and infill where appropriate. (In fact, we are presently working with Mission Housing in San Francisco to use the LEM as part of an effort to create more affordable housing in the Mission District.) In addition, location efficient areas could experience concurrent commercial development, helping to create more self-sufficient communities with even less of a need for driving. Last but certainly not least, the public transportation arteries that make location-efficiency possible should receive increased support and funding as a direct result of the LEM.

THE LEM IS PART OF A LARGER EFFORT that looks at how cities can grow without putting undue strain on scarce resources and support services such as transportation, water, sewer, electric, gas, etc. By encouraging a shift toward more investment in location efficient neighborhoods, the LEM can help promote a sensible distribution of future population growth.

Long term, the LEM hopes to serve as a catalyst for promoting sustainable land use, increasing investment in public transit, and making cities and communities more livable as a whole. To be truly effective, of course, this effort must be a collaboration of government, developers, urban planners, environmentalists, community groups, and business people. We are actively working to make that multi-interest partnership a reality.

The project is currently funded by the Federal Transit Administration and the Environmental Protection Agency, with HUD and the Department of Energy also expressing an interest in providing support. The LEM is endorsed by the President's Council on Sustainable Development and is a core element of the National Partners in Homeownership Campaign.

THE LEM DEMONSTRATION, the first phase of the project, initially targets three metropolitan areas: San Francisco, Los Angeles, and Chicago. We have begun preliminary discussions with local governments whom we are asking to become our partners in the test phase of the LEM. We plan to work with several banks in each city to serve as lenders for the test and also anticipate the secondary market, including Fannie Mae, will become active partners in this venture. The First National Bank of Chicago and First Nationwide have agreed to work with us toward the submission of an application to Fannie Mae's Experimental Underwriting Initiative; they will also supply advisors to help us develop the market test for the LEM. We are looking for other interested lenders to join in this ground-breaking demonstration.

LOOKING TOWARD THE FUTURE, we expect to expand the LEM program to other metropolitan areas throughout the country; we have already received inquiries from over twenty cities. Our goal is the eventual universal acceptance of the principles of location efficiency within basic underwriting guidelines.

IF YOU ARE INTERESTED IN WORKING WITH US in the creation and implementation of this new mortgage concept, you can contact Ronnie Himmel at the Natural Resources Defense Council, 71 Stevenson Street, San Francisco, CA 94105. Her phone number is 415-777-0220 x 305.

Testimony Submitted by the

Edison Electric Institute

on

Deductibility of Asbestos Removal Costs

July 16, 1996

The Edison Electric Institute (EEI) appreciates the opportunity to submit testimony (for the Record) for the July 16 hearing on the tax code provisions that have an impact on land use. EEI is the association of our country's shareholder-owned electric utilities which serve 76% of all ultimate electric customers in the nation. EEI commends the Subcommittee on holding a hearing that addresses a number of provisions in the Internal Revenue Code which impact land use. We believe that the hearing is particularly appropriate in light of the continued uncertainty that exists with respect to deductibility of environmental remediation costs, specifically the deductibility of asbestos removal costs.

INDUSTRY PRACTICE

EEI is very concerned about the tax treatment of asbestos removal costs because electric utilities have used asbestos extensively as an insulator for steam generation electric equipment. In an electric generating plant, steam boilers produce high-temperature steam. In order to reduce heat loss, asbestos insulation is attached to the walls of the boiler and turbine electric generator, and is wrapped around all associated piping. Asbestos insulation is removed during routine inspections of the piping and turbine. Once removed, the asbestos is not reused. It is also possible that, with age, insulation will begin to disintegrate, thereby requiring total removal or encapsulation. It is generally with respect to this latter use of asbestos as insulation that federal and state occupational safety and health laws require safe removal and replacement of the material.

TREASURY/IRS POSITION

On February 10, 1994, 22 members of the House Ways and Means Committee sent a letter to the Honorable Lloyd Bentsen, Secretary of the Treasury, expressing their interest and concern regarding the appropriate treatment of environmental remediation expenditures. The letter was sent in response to two Technical Advice Memoranda (PLR 9240004 and PLR 9315004) that required taxpayers to capitalize a substantial portion of these costs. The letter emphasized that the federal tax treatment of environmental remediation expenditures is a key component to this nation's commitment to cleanup and preserve the environment. The letter also emphasized that government policy should encourage taxpayers to promptly initiate remediation activities and that the IRS

interpretation of the law in this area could be a disincentive for companies to cleanup. EEI strongly endorses the tax policy principles set forth in the February 10, 1994, letter.

In response to the letter of the House Ways and Means members and submissions by EEI and others, the Internal Revenue Service (IRS) held in Revenue Ruling 94-38 that hazardous waste remediation expenses were deductible as ordinary and necessary business expenses. This ruling reversed the one technical advice memoranda (PLR 9315004) but did not reverse the other PLR (9240004) dealing with removal and replacement of asbestos insulation used to insulate equipment.

EEI had hoped that, based upon the rationale underlying Revenue Ruling 94-38, the IRS would revoke PLR 9240004 as well. Clearly, asbestos removal costs are similar to the costs incurred in Revenue ruling 94-38 for land remediation and groundwater treatment. Under Revenue Ruling 94-38 such costs are expensed. The same result should follow in the case of asbestos removal. Revenue Ruling 94-38 rejected the conclusion in PLR 9240004 that the cleanup and removal expenditures should be capitalized because the costs enhanced the value of the equipment. Revenue Ruling 94-38 also rejected the premise underlying PLR 9240004 that the costs of asbestos removal are part of a plan of rehabilitation associated with the costs of installing an alternative insulation. The cost of removal of asbestos is not incurred in connection with the installation of new insulation. It is incurred because taxpayers are required to comply with federal and state environmental laws and regulations.

CONCLUSION

Asbestos removal costs affect numerous taxpayers. For the past two years, EEI and many other organizations and corporations have been meeting with the IRS and Treasury requesting clarification on the deductibility of asbestos removal costs. No guidance has been received to date. For this reason, EEI urges the Oversight Subcommittee to encourage the IRS and Treasury to issue guidance confirming the deductibility of asbestos removal costs.

Thank you for giving EEI the opportunity to submit our statement.

Written Statement of

THE CITY OF HOUSTON
by
The Honorable Bob Lanier
Mayor

Submitted for the

SUBCOMMITTEE ON OVERSIGHT of the COMMITTEE ON WAYS AND MEANS U.S. HOUSE OF REPRESENTATIVES

HEARING ON THE IMPACT OF TAX LAW ON LAND USE

July 25, 1996

Introduction: Tax Incentives for Job Creation

Chairwoman Johnson and Members of the Subcommittee, thank you for allowing the City of Houston to submit testimony relating to the impact of tax law on land use. We appreciate the opportunity to discuss the need for tax incentives to help revitalize distressed communities, including certain neighborhoods in the City of Houston.

The designation of certain distressed areas as Empowerment Zones (EZ) and Enterprise Communities (EC) in 1994 was a crucial step toward helping such communities fight powerty, crime, and unemployment by fostering economic growth. Congress and the Administration are now considering proposals to expand the EZ/EC program, thereby giving such assistance to even more communities in need. However, revitalization of blighted urban areas will be limited and lengthy at best until more focused tools are available to cities. Improvement of infrastructure needs, large scale demolition of unsafe structures, new housing developments, crime reduction strategies, etc. are all extremely important but they will not bring back to these urban areas the one missing ingredient to long term stabilization - new and expanded job creation.

Wage tax credits and brownfields clean-up incentives are two powerful tools which we believe can play an important role in bringing businesses and jobs to communities like Houston. We urge you to support the adoption and expansion of these incentives in order to help the revitalization of American cities.

The Plight of the Inner City

It is often difficult for large cities to compete with the suburbs that surround them. Land is much more plentiful, land cost is substantially lower, and environmental problems are not as pervasive. During the 1980s, Houston's inner city lost approximately 100,000 residents to the suburbs for some of these reasons. Businesses were closed and boarded up. Absentee landlords neglected their residential properties. One of the greatest losses was that dollars earned by the remaining residents did not stay in the neighborhood.

The only way that Houston's inner city can overcome such deterioration is to provide incentives that will make the city attractive to potential developers and business owners and allow the inner city to compete on a level playing field. Utilization

of changes in the tax code may provide some of the incentives necessary to bring economic redevelopment back to urban areas like Houston. As a first step toward such revitalization, the City of Houston was designated a Federal Urban Enhanced Enterprise Community in December 1994. The Enhanced Enterprise Community (EEC) comprises an area of severe disinvestment, and is eligible to receive \$25 million in social service and economic development initiative grant funds.

However, two major incentives are not available to Houston under current law -- wage tax credits and brownfields remediation deductions. The wage credit program is only available to those few communities that were designated as Empowerment Zones in 1994. Brownfields remediation deductions are part of a recent proposal that has not yet been enacted and, as such, are not currently available to potential business developers.

Need for Tax Incentives

New, sustainable job creation is an absolute necessity if the EEC is to improve and stay healthy. The ability to utilize wage tax credits as a tool to create these jobs would greatly enhance the City of Houston's ability to revitalize and stabilize these neighborhoods. New businesses or the expansion of existing businesses would mean that dollars would stay in the community. Jobs created with the assistance of the wage tax credit would mean that residents could now find employment in their neighborhood. Job transportation would become less of an issue and less of a cost, since residents would have no problem getting to a job in their own neighborhood. Wage tax credits would be an incentive for employers to hire youth, providing opportunities for disadvantaged residents that would otherwise not be available to them.

Furthermore, businesses would have a great incentive to expand within the EEC boundaries. Often, it is extremely difficult for new businesses or expanding entities to locate in marginal areas because initial cash flow is low. These credits would have a direct impact on net profits, which would enable businesses to take a chance on locating in an area that might not otherwise be possible.

Tax incentives could also help businesses overcome the environmental challenges to expansion. The City of Houston is extremely unique in that it is a city without zoning. Due to the historical lack of land use control measures, it is not surprising to find inner city neighborhoods surrounded by industrial properties. Many of these properties are now vacant and redevelopment is not occurring mainly due to the possibility of environmental problems.

Houston was recently awarded a brownfields grant, and the majority of the grant focus area is in or adjacent to the EEC. Yet adaptive reuse of the old industrial sites would be a much easier task if the potential private sector developer had the ability to write off environmental clean up costs quickly. The business would benefit both from the possible lower purchase cost and the developer's ability to recapture start up costs from wage tax credit savings.

Solutions: Making the Incentives Available

Earlier this year, President Clinton proposed an expansion of the EZ/EC program. Based on the Administration's plan, legislation has been introduced in both the House and the Senate to designate an additional 20 Empowerment Zones and 80 Enterprise Communities. S. 1911, introduced by Senators Moseley-Braun (D-IL), Jeffords (R-VT), and D'Amato (R-NY), and H. 3747, introduced

by Representative Rangel (D-NY), embody the Administration's proposal to encourage economic redevelopment through utilization of tax code amendments. These bills would include new tax incentives to encourage brownfields clean-up. However, only two of the newly designated Empowerment Zones would be eligible to receive wage tax credits.

Rep. Foglietta (D-PA) has introduced a bill, H.R. 3241, that would allow an additional 9 areas to be designated as Empowerment Zones and receive the wage tax credit, along with other tax incentives for growth, including a credit for brownfields remediation costs. Other measures, including bills introduced by Senator Abraham (R-MI) and Senator Lieberman (D-CT), would expand the incentives available to distressed communities but would not specifically provide a wage tax credit or brownfields clean-up deduction/credit to businesses and developers.

We believe that the expansion of wage tax credits to more distressed communities and the adoption of brownfields clean-up incentives are crucial to the creation of jobs and the revitalization of deteriorated neighborhoods. We hope that you will support legislation to enact these important incentives so that the City of Houston and other inner cities can bring jobs and businesses back to the communities where they are so deeply needed. On behalf of the City of Houston, I thank the Subcommittee for the opportunity to testify on this issue that is so crucial to our nation's cities. Please do not hesitate to contact us if we can provide you with any additional information on this important matter.

Committee on Ways & Means Subcommittee on Oversight

Hearing on the Impact of Taxation on Land Use

Tuesday, July 16, 1996, 11:00 a.m. B-318 Rayburn House Office Building

Representative Charles B. Rangel of New York

Madame Chairman. Today the Committee sits to hear testimony of the impact of tax policy on land use. 1 thank you for allowing me to offer testimony in support of H.R. 3747, the Community Empowerment Act.

This legislation will expand upon the Empowerment Zone and Enterprise Community concept, which was passed as part of the Omnibus Budget Reconciliation Act of 1993. OBRA 93 authorized a Federal demonstration project of 9 Empowerment Zones and 95 Enterprise Communities that were designated through a competitive process. Among the benefits include tax incentives that: 1) offer an employment and training tax credit; 2) provide an additional \$20,000 per year of Section 179 expensing; and 3) create a new category of tax-exempt private activity bonds.

H.R. 3747 also provides for tax incentives for the cleanup for as many as 30,000 brownfields, contaminated and polluted former industrial sites that lay abandoned and underutilized. Many of these areas are located in the distressed communities. Significant economic benefits can be realized if these sites are cleaned up and made available for use.

Under current law, cost incurred for new buildings or for permanent improvements made to increase the value of any property are not currently deductible, but must be capitalized. Under The Community Empowerment Act, certain remediation costs would be deductible if incurred while restoring a qualified site.

This incentive is expected to cost approximately \$2 billion while leveraging \$10 billion in private clean-ups nation-wide. With the possibility of returning as many as 30,000 brownfields to productive use and over 500 communities ready to participate, we must move forward with this responsible legislation.

H.R. 3747, The Community Empowerment Act is the next logical step to the Empowerment Zone initiative. Leveraging public sector resources to enable private-sector community investment is a fiscally responsible means of promoting community development and prosperity. I welcome my colleagues to join me in supporting this legislation.

Statement of the Hon. Bill Thomas HON. WILLIAM M. THOMAS Subcommittee on Oversight July 29, 1996

I appreciate this opportunity to comment on the ways in which federal taxes influence land use in the country. One million acres of farm land in the United States will be eaten up by parking lots, freeways, and suburban growth this year. In fact, within the hour, one acre of precious farm land in the Central Valley of California will be taken out of production. The Central Valley of California currently produces over \$13 billion in agriculture produce and feeds millions in the U.S. and around the world.

This rural ground also provides vital habitat for thousands of animal species that range from kangaroo rats to white tailed deer. Farm land provides for a much better habitat for animals than a parking lot does. It is equally important that we provide incentives to people to keep their land in a natural state so that animal habitat can be preserved. Farm land in areas surrounding cities is being displaced by urban development at one of the fastest rates in history, and for this reason our farmers have been placed under new pressures.

When the great cities of our country were settled, they were developed near rich agricultural land to assure an adequate food supply. As urban areas continued to sprawl, many fertile acres were consumed and many more were placed at risk. Over the past ten years urban sprawl has eaten up over 26 million acres of productive farmland. In relative terms this equates to an area the size of the entire state of Kentucky displaced by urban development. Most of the farmland lost in the country has been located in urban-influenced counties where the density is at least 25 persons per square mile. A recent study by the American Farmland Trust estimated that the farm land in the urban-influenced counties was 2.7 times more productive than the remaining United States counties.

87% of our domestic fruit and nut production is also grown in these susceptible counties.

Farming is a capital intensive business and we can use that knowledge to design tax incentives to ensure farmland preservation. For example, farmers putting in a wine grape vineyard will encounter four year development costs of over \$17,000 dollars per acre. Pistachio farmers should expect at least \$7,000 dollars in preproductive costs per acre, and olive growers \$5,000 dollars an acre. These costs could literally double or triple dependent on the value of the land.

Aside from the high start up costs of orchards and vineyards, U.S. farm real estate values also continue to rise. According to statistics compiled by the U.S. Department of Agriculture the value U.S. farm real estate has risen 6.4% over the past year to \$832. This \$832 figure may be rising, but it still does not nearly reflect the cost of acquiring a prime piece of farmland in highly productive, urban-influenced states like California and Florida. An average piece of farm land in California and Florida is worth over \$2,000 and can be worth as much as \$17,000.

Along with high costs, farmers are also plagued with storms, disease, and pests that destroy many acres of orchards and vineyards annually. Some of this costly acreage has not even reached a productive state. Crops like tangerines and cherries can take five to six years to reach productivity. In a natural disaster a farmer with a vineyard or an orchard still in its preproductive state may have trouble sustaining large losses because he has not even begun to receive a return on his investment.

After considering land use in California, I have developed two incentives that would amend the tax code and keep families in farming and land in rural uses.

I recently introduced H.R. 3749 to promote replacement of crops destroyed by casualty. This bill will provide an incentive to replant by allowing farmers to deduct the cost of replanting their destroyed crop in the event of freezing temperatures, disease, drought, or pests, all events that cannot be controlled. It also allows farmers to deduct the costs of replacing key infrastructure.

The need for this legislation is clear when one considers the way in which the farmers have to make decisions once a disaster strikes. Ordinarily, farmers have to capitalize the costs of planting a new orchard or vineyard. If a disaster strikes, they would still be forced to capitalize the costs of replacing essential infrastructure, trees and vines and other some other costs related to replanting. It will be years before those costs are deductible because of the long preproductive periods trees and vines may require. A farmer facing massive new investment requirements without deductions or income may decide to sell out. H.R. 3749 helps keep farmers on the land by allowing them to deduct more of the costs of replanting.

Estate taxes can also be extremely burdensome. According to the U.S. Department of Agriculture the average size farm in the U.S. is 469 acres. The land alone of an average California farm is worth over \$1 million and can be worth as much as \$8 million. Such farm values are the reason I introduced H.R. 520 to double the current maximum benefit under the estate tax special valuation deduction. A farmer can be worth millions in terms acreage, but it does not necessarily mean that his estate will have the money to pay estate taxes. Estate taxes can force family farm operations to be split into parcels and sold to developers just to cover taxes. H.R. 520's increased deduction of \$1.5 million would allow for more continuity in farm acreage, making it easier to transfer land between generations and avoiding the need for families to split up their land to pay off the estate tax.

Prime agriculture land is being urbanized as we speak. Providing these small incentives to America's farmer would encourage families to provide a more natural habitat for our wild life as well as a secure and abundant food supply for the 21st century.